

Carbon Market Watch's reply to DG COMP public consultation on draft ETS State aid Guidelines

Carbon Market Watch welcomes this opportunity to feed into the public consultation.

Given that there is as yet no hard evidence of carbon leakage caused by indirect costs passed through by power companies, Carbon Market Watch cannot support using taxpayer money to protect industry from an unproven “carbon leakage risk”. Indirect cost compensation, coupled with free allocation of emission allowances, undermines the polluter pays principle and removes market incentives for energy intensive industries to take steps towards energy efficiency, decarbonisation and investments in cleaner production. The state aid schemes implementing these guidelines in essence lead to subsidies for more pollution, under the guise of tackling a problem that does not exist.

In addition, if not limited over time, state aid amplifies political lock-in by subsidising these industries - creating vested interests.

Should compensation of indirect costs be maintained, then it needs to be limited in scope and time, and help deliver greenhouse gas emission reductions as effectively as possible. In that sense, **we see an encouraging improvement** between the draft “Guidelines on certain State aid measures in the context of the system for greenhouse gas emission allowance trading post 2021” (referred to throughout this document as the “draft guidelines”) compared to those that have been in place for 2013-2020 (“old guidelines”).

However, there **continue to be numerous other avenues to significantly improve the scheme**. We identify the following main points for improvement:

- The use of only fossil fuel generation capacity to determine the regional CO₂ emission factors. This method does not fit the current trends in the power sector¹, and leads to even more over-compensation for industry. In light of coal phase-outs and the pressure on the power sector to decarbonize, it is **wrong to assume that only fossil fueled power capacity will determine electricity prices throughout the EU until 2030**. The CO₂ factors should be based on all electricity generation capacity and storage, and be updated annually.
- The potential inclusion of additional sectors through an intransparent qualitative assessment is problematic. **Sectors that did not make it through the quantitative assessment should not be let in through the back door**. Especially the potential inclusion of the Manufacturing of plastics in

¹ For example, in 2019, coal generation fell 24% in the European Union, and is now less than half the level in 2007. This led to a 12% fall in European power sector CO₂ emissions in 2019 alone – the biggest fall since at least 1990. (Source: Sandbag, Agora energiewende 2020)

primary form is worrying. While more effort is being put into developing more circular products and increasing material efficiency, the inclusion of this sector in these guidelines risks undermining these efforts by actively subsidising primary plastic production. There should **not be a qualitative assessment** for sector eligibility.

- A **sunset clause and degressive aid intensity** should be included as an effective way to ensure indirect cost compensation is phased out over time. Discouraging aid dependency is a key principle for EU state aid guidelines.
- **Regional CO2 factors and electricity consumption efficiency benchmarks** should be set in **line with reality and the EUs decarbonization strategy** and trends. They should also be **sharpened annually and automatically**. A **mid-term revision for reviewing the methodologies** used to calculate these variables is needed.
- There should be an **explicit end to linking EU ETS revenues and indirect cost compensation**.
- There needs to be **more transparency at EU level** on how Member States transpose and use these guidelines - we are talking about taxpayer money and intra-EU competitiveness, and therefore a high level of transparency is vital to maintain trust and accountability.
- The **Article 10c derogation should explicitly rule out all support for fossil fuel electricity generation and infrastructure**

The remainder of this contribution to the consultation is structured as follows:

- An outline of the positive changes we see between the draft and the old guidelines (section 1).
- An overview of unused opportunities for improvement (section 2).
- A more detailed assessment of the various components of these draft state aid guidelines and how they should be adapted (section 3).
- Carbon Market Watch's key recommendations (section 4).

1. Good progress...

- The much-needed **conditions for companies to receive state aid are valid and should be strengthened** to ensure only investments that have environmental benefits and are additional are subsidised through taxpayer money.
- **Fully renewable electricity contracts are now covered**, resolving the current perverse incentive where clean electricity consumption is penalised. This is a much-needed improvement and should be kept.
- The **initial reduction of the list of sectors is welcome and should be continued**, as the size of the payments under the state aid guidelines needs to be reduced over time.
- Some **key variables would be brought closer to reality**, and could finally be updated over the lifetime of the guidelines. This includes the use of actual output levels, and the possibility of a mid-term review of the electricity consumption efficiency benchmarks and regional CO2 factors. The CO2 factors would also be further differentiated, with more Member States defined as 'regions'.
- The **ex-post adjustment mechanism** to ensure over-payments are repaid to state budgets is a positive evolution.
- The sections on **Transparency (Section 6) and Reporting and Monitoring (Section 7)** have been significantly fleshed out, including an exhaustive list of data to be reported and published by the Member States. Ensuring that civil society and researchers have an insight into how much money each member state is giving to individual companies will do much to improve the transparency of the system.

2. ... but a lot remains to be done

However, the **draft guidelines still need significant improvements**, even with regards to some of the positive elements mentioned previously.

- There remains a **lack of clear evidence to prove that this scheme is indeed necessary and an efficient use of taxpayer money**. Even more worrying is the assertion in the explanatory note accompanying the draft guidelines that the Commission is still working on an impact assessment on options to be used in the final guidelines. This assessment should have been completed before the draft guidelines were published to ensure policy makers and stakeholders were informed as much as possible.
- The **state aid does lead to disruptions to the internal market**. Wealthier Member States are leading a race to the bottom. The way to remedy this is to discontinue this state aid scheme.
- The **conditions placed on companies to receive state aid should be strengthened**. The state aid granted should all be used for investments in energy efficiency, renewable energy production and

consumption, and emission reductions. Furthermore, as state aid should be focused towards triggering additional clean investments, **an additionality criteria is necessary.**

- Member States should also **publicly report on how industry fulfilled these conditions** to provide data on how the state aid is actually used by companies. This reporting should include an overview of how much taxpayer money was used for either energy efficiency investments, renewable energy production, renewable energy purchasing and emission reduction investments - and what the results of these various investments were.
- The **proposal is incomplete**, with placeholders in it for some very important information that should have been available for stakeholders prior to this consultation. Critical information that is missing includes the maximum regional CO2 factors and the GVA threshold for additional compensation. These variables, if badly set, could make the scheme even more generous than it is.
- While the list of sectors deemed eligible through the quantitative assessment has been reduced, the door has been left open for another four sectors to be added through an in-transparent black-box qualitative assessment. The qualitative assessment has not even been included in the draft guidelines, but solely referred to in the accompanying explanatory note. This **qualitative assessment should not be further developed and implemented, but scrapped altogether.**
- The **CO2 factors should not be based solely on emission intensive electricity generation** - but take the full and rapidly declining carbon content of energy mixes across the EU into account. For example, last year, coal generation fell 24% in the EU, leading to a 12% fall in European power sector CO2 emissions in 2019 alone – the biggest fall since at least 1990 (Sandbag and Agora Energiewende, 2020).
- There is some confusion between the proposal and the explanatory note on the electricity consumption efficiency and fall back **benchmarks** and how they should be updated. At the very minimum, they should be **set in a similar way as the benchmarks for free allocation** - using the average of the 10% most efficient EU installations and with annual improvement rates to be applied. But ideally they are **set using Best Available Technologies from relevant BREF documents.**
- The potential mid-term review of some key variables does not go far enough. **The CO2 factors and the benchmarks should be updated annually and automatically.** As mentioned above, the benchmarks should at least be improved annually in similar fashion as the benchmarks for free allocation.
- The **estimates for EUA prices should be replaced by actual EUA prices** rather than averages of forward prices. If actual output levels can be used, why not actual price levels?
- **Indirect cost compensation should be explicitly delinked from EU ETS auctioning revenues.** The soft cap of 25% implies that state aid can count towards article 10(3) of the EU ETS Directive.

However, it clearly does not fulfill the conditions under Article 10(3) of the EU ETS Directive - even when including the conditions in the draft guidelines. The state aid itself, as determined by the draft guidelines, will not be fully used to reduce emissions, develop renewable energy, push energy efficiency, or any other of the areas identified in Article 10 (3). The ETS revenues should be used by Member States to fund effective climate action, not subsidies for industry.

- The **Article 10c Derogation should explicitly exclude the possibility of fossil fuel generation capacity and infrastructure** receiving state aid.

3. Deeper dive into the various elements of the draft guidelines

3.1 Raison d'être of the guidelines

State aid for indirect cost compensation should protect sectors that are exposed to a “genuine risk of carbon leakage” due to indirect costs passed on in electricity prices, if the protection does not cause undue distortions of competition in the internal market. This implies that:

1. The risk of carbon leakage due to indirect costs is genuine and significant
2. Electricity prices for large industrial consumers have increased under the EU ETS
3. Distortions to the internal market are minimal

None of these three has been sufficiently proven by either the European Commission nor by industry stakeholders. Indeed, the European Commission's 2019 report on 'Energy prices and costs in Europe'² states clearly that over 2015-2018 electricity prices for industry have been falling significantly, while EUA prices remained relatively stable over the same period.³ Furthermore, there is a large divergence between electricity prices for industry across EU countries (for example in 2017 electricity prices for Hungarian electricity-intensive industry was around 50 EUR/MWh, while it was nearly 120 EUR/MWh in Germany) - these questions remains: **which playing field are we trying to level, and is it really 'unlevel' due to climate policy?**

In addition, it is hard to imagine that there have not been significant distortions to the internal market for two reasons: **product substitutes face unfair competition, and industrial sectors are treated differently depending on the practices of the countries** in which they are active.

State aid should not be given to sectors with less carbon and/or electricity intensive substitutes as otherwise taxpayer money is being used to subsidise carbon pollution and wasteful electricity consumption. The state aid scheme - and countries implementing it - does not necessarily support more

² Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions - Energy prices and costs in Europe COM(2019) 1 and SWD(2019) 1

³ EEX Auction clearing prices (source: EEX), comparing January 2015 and January 2018.

energy and/or emissions efficient products and producers. In fact, **indirect cost compensation could even improve the competitive position of the more inefficient installations within a sector.**

Countries are free to provide state aid following these guidelines, but there is no obligation. This creates market distortion for industrial sectors due to a lack of harmonization, which is evidenced by electro-intensive industries strongly calling for the development of an EU-wide instrument to replace the national state aid mechanisms during the post- 2020 review of the EU ETS Directive. In principle, **Carbon Market Watch supports full harmonization through the approach to no longer allow Member States to have compensation schemes in place.** This would lead to a level playing field and equal treatment of all installations across the EU.

In its current form, the draft guidelines allow richer countries with budgetary space to provide subsidies to their domestic industry using state aid, forcing others to also give state aid and starting a race to the bottom. The internal market is further compromised due to Member States having the right to exclude sectors and installations from their national state aid schemes. In case compensation of indirect costs is maintained, a significant increase in EUA price would potentially dramatically increase internal market distortion between countries granting state aid and countries that do not.

As stated in the draft guidelines, the state aid scheme needs to fulfill three key principles: the aid must be necessary to achieve the environmental objectives of the EU (necessity of the aid), the aid must be limited to the minimum needed to achieve the environmental protection sought (proportionality of the aid), and the aid must change the behaviour of the undertakings concerned in such a way that they engage in additional activity (behavioural change due to aid).

Again, there is insufficient evidence that indirect cost compensation fulfills all, or indeed any, of these principles. **The Commission must prove that this state aid scheme does indeed ‘result in a higher reduction of GHG than would occur without the aid’⁴.**

In addition, **indirect cost compensation, coupled with free allocation of emission allowances, undermines the polluter pays principle and removes market incentives for energy intensive industries to take steps towards decarbonisation.** It is hard to see how the indirect cost compensation leads to behavioral changes for installations as they are shielded from environmental externalities of their electricity consumption. The conditionality provisions in the draft guidelines do go some ways to mitigate this issue - but should be further strengthened.

It is important to highlight that the burden of proof lies with the EU institutions, national governments and private companies that will benefit from the scheme, and that this burden of proof must be fulfilled before the state aid scheme enters into force. In this light, **Carbon Market Watch requests that the Impact Assessment being prepared by the European Commission questions the raison d’être of the draft state**

⁴ Paragraph 6 of the Communication From The Commission Guidelines on certain State aid measures in the context of the system for greenhouse gas emission allowance trading post 2021 [DRAFT]

aid guidelines, before focussing on the efficiency and effectiveness of the various options for the revision. As the consultancy report released by the European Commission admits there is currently no hard evidence of carbon leakage due to indirect costs.⁵

Determining the existence of “genuine risk of carbon leakage” and pass-through of indirect costs has to be conducted at the level of individual Member States. There is no rationale to support state aid in countries where electricity prices for large consumers have not changed due to the EU ETS or where the energy mix is largely decarbonized. In its current form, the state aid guidelines extend the dependence on fossil fuel generation in a limited number of countries while other countries are moving beyond this issue.

If indirect costs were indeed to be proven to be such an important issue, why is the EU only focusing on industrial electricity consumers? Analysis for the European Commission clearly states that larger electricity consumers have stronger bargaining power, and can translate this market power into lower electricity prices⁶. If ETS costs are indeed passed through, and industry faces significant indirect costs, then surely so do households - likely to a much higher degree.

Under the California cap-and-trade system indirect costs are also compensated, but over 2014-2016 85% of all compensation went to households, not industry. Of the 15% that went to industry approximately half went to small businesses⁷. **If the EU wants to limit any unproven, unintended and negative impacts of the EU ETS, then indirect cost compensation for households should be on the table as well.** This would strengthen public support for the transition, and be a **valuable tool for tackling inequality across the EU.**

3.2 Rigidity versus flexibility

The final guidelines should be more in line with reality than the old guidelines. That means that instead of variables being set in stone for a decade, they need to be able to evolve in a positive direction in the short term.

The draft guidelines already contain a positive evolution in that sense. Some key variables would be closer to reality, and could finally be updated over time. Actual output levels will now be used, and energy efficiency benchmarks and regional CO2 factors will be subjected to a mid-term review.

This does, however, not go far enough. **The benchmarks and the CO2 factors should be adjusted annually and automatically⁸** to incentivise industry to continue to improve their energy efficiency and take the

⁵ ADE and Compass Lexecon (2020), Combined retrospective evaluation and prospective impact assessment support study on ETS State Aid Guidelines, commissioned by DG Competition. p 9.

⁶ CEPS and Ecofys (2018), Composition and Drivers of Energy Prices and Costs: Case Studies in Selected Energy Intensive Industries

⁷ CARB Summary of Vintage 2014-2016 EDU Allocated Allowance Value Usage

⁸ Note a discrepancy on updating benchmarks in the explanatory note and the draft guidelines themselves. In the draft guidelines the definition of the benchmarks (item 13 under 1.3 definitions) indicates that there will be annual updates. Paragraph 66 of the draft guidelines, however, states that there will only be a mid-term review. The explanatory note states that there will only be a mid term update, but that the Commission is considering aligning the methodology for updating the benchmarks with article 10a(2) of the EU ETS Directive on annual updates to the free allocation benchmarks.

rapidly changing energy mixes in the EU into account⁹. The **benchmarks especially should be set at a very strict level, using Best Available Technologies as the starting point, and include annual improvement rates** (similar to the benchmarks for free allocation). A mid-term and an end-of-trading-phase review would assess if they are still in line with real world progress and review the methodologies used to determine these variables. In case of rapid technological progress, more regular updates would be preferred.

In this regard, it is encouraging that the Commission indicates that even the final guidelines will not be set in stone - but kept consistent with other elements of the Green Deal, hopefully including the proposed border carbon adjustment. However, clarity is needed on how an intra-phase 4 review could be triggered.

It is important to note that there is already a possibility for revisiting indirect cost compensation under Article 30 of the EU ETS Directive. Such a review has, however, never been done – and there is no clarity on what would trigger the Commission to start the review. This should be specified and operationalised sooner rather than later, especially in light of upcoming discussions on Border Carbon Adjustments and the need for more ambitious NDCs to be presented this fall at COP26 in Glasgow. **The revision of the draft guidelines would be an appropriate vehicle for operationalising Article 30 of the EU ETS Directive.**

3.3 Conditionality

The Commission proposal adds much-needed conditions for companies to receive state aid. These conditions could lead to state aid for indirect costs finally having environmental benefits and channelling resources towards renewable energy deployment. They can also reduce the dependency of companies on state aid over time in two ways.

Firstly, companies would need to buy less electricity from utilities by either improving energy efficiency or by increasing on-site renewable energy production. This would limit exposure to possible indirect costs.

Secondly, they will push electricity consumption efficiency benchmarks downwards, reducing the payouts of state aid over time.

Carbon Market Watch strongly welcomes the addition of conditions for companies receiving state aid. Industry has maintained in the past that indirect costs undermine their ability to invest - these conditions answer those requests. **By investing in emissions reductions, energy efficiency or renewable energy companies are being pushed to shield themselves from possible indirect and direct costs.** However, there are six issues we recommend to revise and improve:

1. All state aid received should be used for energy efficiency gains, renewable energy production/purchasing and emission reductions. In that sense the various options for companies

⁹ For example, in 2019, coal generation fell 24% in the European Union, and is now less than half the level in 2007. This led to a 12% fall in European power sector CO2 emissions in 2019 alone – the biggest fall since at least 1990. (Source: Sandbag, Agora energiewende 2020)

(a-c under paragraph 54) should explicitly include the **obligation to use all state aid received**. Any state aid that is not used for these purposes should be returned to the state coffers.

2. Condition (a) - implement findings from the energy audit - is a very weak condition. Electro-intensive companies should already be engaging in energy efficiency investments (especially with short payback times), therefore this condition does not add any pressure. This weak condition undermines the conditionality through the 'or' link between the conditions, and therefore **condition (a) should be dropped, or the 'or' link should be an 'and' link between the various conditions**. In addition, it seems that in some countries there is already a legal obligation for large energy consumers to engage in audits (under transposition of the Energy Efficiency Directive). Carbon Market Watch calls upon the Commission to investigate if this might be the case - if so, legal compliance would be rewarded with state aid - this is not allowed under the EU State Aid framework.
3. The use of **longer payback times for investments** - 15-20 years would be more appropriate than 5 years to ensure valuable opportunities for energy efficiency gains can be tapped for which companies currently might not have sufficient incentive.
4. One of the conditions states that the 'cost of their investment is proportionate' - this wording is vague and should be clarified to ensure that it is interpreted in the same way by all EU Member States.
5. **Condition (b) should be adapted to ensure PPAs are incentivized with renewable energy producers, instead of "carbon-free" power.**
6. **State aid should be used to trigger additional investments.** Companies already have a strong financial incentive to do energy audits and follow the recommendations - they will save energy and therefore reduce costs. State aid should not be crowding-out investments that companies would already make, but focus on pushing additional investments. In some countries energy audits and the implementation of the main findings are already mandatory. Therefore an **additionality criteria should be added**.

Strong monitoring and enforcement of these conditions will be critical to ensure that the conditions are met and state aid at least has some environmental benefits. Carbon Market Watch requests the Commission to develop a monitoring scheme where company (and Member State) compliance with paragraph 53 and 54 is independently verified. **State aid should be suspended and, where appropriate, repaid if conditions are not met.**

3.4 Transparency

There is a general lack of transparency throughout the state aid schemes and the draft guidelines.

The explanatory note indicates that the Commission may use a qualitative assessment to add sectors to the list of eligible sectors. This qualitative approach is not defined, nor are the criteria which will be assessed. This is problematic as up to 4 additional sectors could be added to the list without any clarity on why they deserve state aid. **The qualitative assessment should be explicitly ruled out.**

In addition, the proposal still contains placeholders for some very important information. Crucially, the regional CO2 factors are kept blank, even though this variable has the potential to make the whole scheme even more generous than it already was during Phase 3 of the EU ETS.

Other important information which has apparently not been decided includes the threshold for the GVA tiered approach and the exact calculations for the fallback benchmark. These fallback benchmarks should in any case be used as little as possible as by now the data for calculating the primary benchmark should be available for all eligible sectors.

Paragraphs 55 and 58 are enormous steps forward to ensure more transparency of the national state aid schemes. However, four improvements could be made:

- 1) One additional step could make a big difference: an **EU level webpage for centralised reporting** on the data under paragraphs 55 and 59 would facilitate independent research, monitoring and accountability. The key principles should be to publish as much as possible, including:
 - a) The principal activity level of beneficiaries published should be as precise as possible - NACE 4 level at the minimum and not NACE group level (as mentioned in paragraph 55.(h)).
 - b) The EUA prices, aid intensity, benchmark and national CO2 factors used to calculate state aid payouts to individual installations.

Some data could be kept confidential for commercial reasons - but this should be limited to the extent possible. Currently, critical data on who receives how much is not publically available. The state aid schemes across Member States use public money which should be spent wisely and carefully. Policymakers should be more accountable with respect to subsidies for industries. A centralised EU reporting website where all relevant data is easily accessible to stakeholders would alleviate some of these concerns .

- 2) It goes without saying that the administrative burden of reporting under the state aid scheme should be limited as much as possible. However, the data to be published by Member States under paragraph 55 does not cause undue administrative burden for SMEs as it should be readily available for either companies or Member States implementing their state aid scheme. Therefore **the waiving of this reporting requirement for Member States (paragraph 56) should be dropped completely.**
- 3) Member States should also report on private sector compliance with paragraphs 53-54. This reporting should include an overview of how much taxpayer money was used for either energy efficiency investments, renewable energy production, renewable energy purchasing and emission reduction investments - and what the results of these various investments were. **The environmental benefits paragraphs 53 and 54 aim at should be quantified and publically reported** to help prove that this state aid scheme finally has some environmental benefits.
- 4) Member States can choose to limit both sectors and beneficiaries of state aid on the basis of **“objective, non-discriminatory and transparent criteria”**. These **criteria should also be published**

to ensure independent oversight and accountability over the use of public funds to subsidize industry.

Separately, paragraph 59 contains a list of data to be reported by Member States to the European Commission, however some of this data should logically be decided at EU level - notably the EUA forward prices and CO2 factors - to avoid further distortion of the level playing field. This seems to be leaving an opening for countries to move ahead with setting these variables themselves (which could again spark a race to the bottom). It is important to specify that this data will be defined at the EU level, and communicated to all Member States to ensure the same data is used throughout the various national schemes.

Finally, the explanatory note states that the European Commission is preparing an Impact Assessment to compare some of the options for the revision. It is unclear which options will be assessed, as only a few clear choices are still left open in the draft guidelines (for example on how to update benchmarks). **Carbon Market Watch would have appreciated analyzing the results of the Impact Assessment before being invited to reply to this consultation.**

3.5 Sector eligibility

Carbon Market Watch welcomes the Commission initiative to limit the number of eligible sectors in the draft guidelines - eight are left instead of the 13 sectors and 7 sub sectors that were eligible during 2012-2020. The number of sectors on the list is, however, less relevant than the expected size of aid to these sectors. Due to the lack of publicly available data comparing the aid to the various sectors over 2015-2020 across the EU it is **challenging to assess whether or not limiting the number of sectors will actually make a large difference in terms of volumes of taxpayer money handed out to industry.**

In addition, the door has been left open for another four sectors to be added through an intransparent qualitative assessment. This assessment is included as an option in an explanatory note, but not in the proposal itself. However, there is no clarity on how it would work and which criteria would be used. All we know is that only four sectors would be considered - Casting of Iron (24.51), Copper production (24.44), Manufacturing of plastics in primary form (20.16) and Other non-ferrous metal production (24.45). **These sectors did not pass the quantitative assessment, and are therefore proven to not be eligible.**

The list risks being expanded through the backdoor due to intense lobbying by these sectors, and not because these sectors actually 'deserve' state aid. **The qualitative assessment should be kept out of the guidelines.**

In any case, the sectors that have not been deemed eligible through the quantitative assessment should not be (re-)admitted to the list. This covers both the four sectors listed above under consideration for the qualitative assessment, and the sectors that have been taken off the list compared with the old guidelines, including: Mining of chemicals and fertiliser minerals, Manufacture of fertilisers and nitrogen compounds,

Manufacture of other organic basic chemicals, Spinning of cotton-type fibers, Manufacture of man-made fibres and Mining of iron ores.

Another concern with the eligibility criteria is that a static “indirect emissions” variable is used to determine the indirect emission intensity criterion. It seems likely that the indirect emissions variable used is defined using an EU-wide average. This leads to two problems.

- Firstly, it creates a vast scope for overcompensation in Member States with largely decarbonized electricity generation capacity.
- Secondly, sectors could be deemed eligible based on the carbon intensity of electricity generation in countries where these sectors are not present or barely active.

If a Member State level number is used, then the mistakes made with regards to the definition of the CO₂ factors cannot be repeated.

- Firstly, it should be the average of the emissions intensity of all generation in that country or region - and not only take fossil fueled generation into account.
- Secondly, it should be updated over time to reflect power sector decarbonisation and assess whether sectors remain eligible for indirect cost compensation.

The latter would help limit state aid over time, and focus it towards those industrial sectors that are deemed by the Commission to ‘need’ it the most. Using a well-defined **Member State indirect emission intensity criterion would also allow for sectors to be included in the state aid scheme only in those countries where indirect emissions are sufficiently high**. This would also limit the possibility of overcompensation and windfall profits.

In addition, individual **installations that do not purchase power from the grid should not be eligible for state aid**. These installations could either generate it themselves (for example by burning flue gasses on site), or have a link with dedicated renewable energy installations. These installations face no indirect costs and for them the state aid scheme is generating windfall profits without any wider benefit to the EU society or economy.

3.6 Timing of granting state aid

State aid should be granted in the year after the one in which costs are incurred. This limits state aid blunting incentives as there is still some exposure to costs.

3.7 Degressivity and aid intensity

It is worrying that the degressive nature of the aid intensity variable has been dropped. This discount factor was crucial to ensure that the state is degressive over time to limit aid dependency - a key principle

in the EU state aid framework. It should also be noted that state aid also needs to be degressive to prevent political lock-in due to strong and concentrated vested interests.

Carbon Market Watch therefore calls for the degressive nature of the aid intensity variable to be reinstated, leading to a full phase out of the aid by the end of this decade. The aid intensity must not exceed 70% of the eligible costs incurred in 2021 and 2022, 50% of eligible costs incurred in 2023 and 2024, 30% of eligible costs incurred in 2025 and 2026, 10% of eligible costs incurred in 2027 and 2028, and 0% of eligible costs incurred in 2029 and 2030. This way there is a predictable phase-out of state aid over time. In any case, the aid intensity variable should not be set higher than the 75% currently proposed.

3.8 Maximum regional CO2 factors

The CO2 emission factors are more differentiated in the draft guidelines compared to the old ones. Even though there are still four regional groupings, the largest one from the old guidelines (Central-West Europe, covering Austria, Belgium, France, Germany, Netherlands and Luxembourg) has been split up, with a smaller one being added (Baltic covering Lithuania, Latvia and Estonia).

Further differentiation between countries and regions could lead to less generous state aid, but this potentially positive evolution could be undermined by the current definition of the maximum regional CO2 factors. The CO2 factors are defined as the average emission intensity of only fossil fueled power plants, meaning that in countries/regions with a largely decarbonized power grid, a small number of plants would set the compensation level for the entire territory.

The current methodology continues with the absurd propositions that carbon intensive electricity generation is the only driver of electricity prices throughout the EU, and that renewable energy and storage will not play a major role setting electricity prices by 2030. These assumptions could lead to massive windfall profits for industry, and disregard:

1. The EU long term climate strategy and planning¹⁰:
 - a. By 2030 carbon intensive generation should account for less than 20% of all capacity
 - b. The power sector will be practically decarbonised by 2050 under all relevant scenarios (1.5 TECH and 1.5 LIFE).
2. Ongoing coal-to-gas switching and coal phase-outs the coming decade
3. The evolution and rapid deployment of renewable energy and storage systems

The maximum regional CO2 factors are critical variables, and if set generously could lead to massive windfall profits. Carbon Market Watch welcomes the Commission's indication that in 2025 the current methodology will be assessed.

¹⁰ The numbers are sourced from the Clean Planet for All Communication and the accompanying in-depth analysis.

However, we invite the Commission to urgently reconsider the current definition of this variable now to take clean energy solutions and storage into account, as their price-setting role will continue to gain importance this decade. **The CO2 factors should take the carbon emissions from the entire power sector into account, and be updated annually to reflect the ongoing decarbonization of the EU power grid.**

3.9 EUA price level

The EUA price as defined in the draft guidelines is also problematic. The low carbon price signal (below EUR 10/tCO₂e) between 2013 and 2018 has led to overcompensation while the ETS market has been in contango (ie. the EUA spot price was lower than the forward price). For example, the report submitted by Belgium (Flanders) in the context of Article 10(a)6 of the EU ETS Directive suggests this was the case in 2017. A forward CO₂ price of EUR 7.8/tCO₂e had been calculated to grant the state aid, while the relevant EUA price for the auctioning revenues was about 25% lower at EUR 5.75/tCO₂e.

Carbon Market Watch urges the Commission to consider using observed EUA prices - if actual output levels can be used, why not actual price levels? Alternatively a true-up mechanism could be used to recalibrate compensation between forward prices and observed prices to avoid overcompensation.

3.10 Product specific electricity consumption efficiency benchmarks

As noted earlier, there is some confusion on the review and updating of the electricity consumption efficiency benchmarks in the draft guidelines and the explanatory note. For Carbon Market Watch, the benchmarks should be adjusted annually to incentivise industry to continue to improve their energy efficiency. To limit further overcompensation, the **benchmarks should be set at a very strict level, using Best Available Technologies, and be sharpened annually in similar fashion as the benchmarks for free allocation.**

The **use of the “fallback benchmark”** remains problematic and **should be avoided** as much as possible. For most sectors and products, the data for using the primary benchmark should be available, and if not, then companies should provide independently verified data before they can demand taxpayer money.

3.11 Output levels

The use of actual output levels is a welcome evolution and should be included in the final guidelines.

3.12 GVA

Carbon Market Watch urges the Commission to include the GVA criteria in the quantitative assessment to limit the risk of overcompensation. If the impact on GVA of sectors is such a core issue, then it should be included as a core criteria for determining sectoral eligibility. Carbon Market Watch urges that the Commission sets the bar at at least 1.5% of GVA.

3.13 Ex-post adjustment mechanism

The inclusion of the ex-post adjustment mechanism is a welcome evolution, the text should be kept as is.

3.14 Interaction with Renewable PPAs and on-site renewable energy production

Fully renewable electricity contracts are now covered, which is a very positive change compared to the old guidelines. However, the draft guidelines should refer to solar and wind power, and not carbon-free generation capacity.

In-house renewable electricity production is still covered though, meaning companies with significant in-house renewable electricity production are being compensated for the ‘opportunity cost’ of selling their electricity on to the grid and shutting down their production facilities. The state aid guidelines should not compensate industry for opportunity costs.

The conditions placed upon companies to receive state aid incentivise investments in on-site renewable electricity production. This means that companies will receive state aid and invest in zero-carbon electricity generation capacity - effectively shielding themselves from indirect costs. However, they will continue to receive state aid even though public funds have been invested in shielding them. This interaction between conditions for receiving state aid and eligibility of installations should be clarified in the final guidelines.

The final guidelines should explicitly exclude state aid for indirect cost compensation when the electricity consumed is produced in-house and/or has no embedded carbon, even if it is the result of the conditions placed upon installations to get state aid in the first place. Publically funded subsidies cannot be open-ended, and this is an excellent avenue for limiting them over time by tackling the core problem - a reliance on fossil fuel generated electricity.

3.15 Use of EU ETS revenues

Indirect cost compensation is still implicitly linked to EU ETS revenues through the soft cap of 25% EU ETS revenues that countries can use for indirect cost compensation. By linking indirect cost compensation to

EU ETS revenues, the European Commission risks allowing countries to use EU ETS revenues to support industry instead of financing the transition to a climate neutral society.

Furthermore, if a limit needs to be placed on indirect cost compensation to limit distortions to the internal market, then:

1. It should be a hard limit - the current soft cap is meaningless as Member States seem to be able to defend breaching it very easily.
2. The limit should not be linked to EU ETS revenues, as these are skewed towards countries that had large and emission-intensive power sectors over the 2005-2007 period. Germany, for example, accounts for around 20% of all auctioning revenues - while France and Romania each account for approximately 5%¹¹.
3. The limit should be based on the importance of the eligible sectors in the national economy.

Article 10(3) of the EU ETS Directive lists areas in which Member States should invest at least 50% of ETS revenues for climate related purposes. Indirect cost compensation does not fall under any of these areas, and should not count towards Member States Article 10(3) commitments - the public finances used for indirect cost compensation could be used more effectively for climate action and the climate neutrality transition.

While the new conditions for receiving state aid do address this issue somewhat, this mechanism remains aimed more at supporting industry rather than pushing climate action. There is a significant risk of state aid being used to crowd-out investments that the recipient would have done anyway. The additionality of state aid funded investments is challenging to prove, and therefore should not be counted towards Article 10(3) of the EU ETS Directive. Furthermore, the state aid revenues should be used to finance climate action in sectors where incentives are limited which is not the case for large industry.

Carbon Market Watch urges an explicit delinking of state aid compensation from EU ETS revenues, and a rethinking of the setting of the limit on compensation.

3.16 Article 10c derogation

The main issue with this scheme is that there is still no explicit exclusion of all fossil fueled generation for funding. Conditions related to climate change are placed on which projects (>12.5 million EUR) are eligible for the competitive bidding process, but these conditions do not rule out investments in fossil fueled generated power. For smaller projects (<12.5 million EUR) the guidelines do not contain any conditions related to climate impacts of projects at all.

There is an urgent need to phase out all - especially public - funding for CO₂ polluting power capacity to avoid carbon lock in and speed up the clean energy transition. While the proposed guidelines do seek to

¹¹ Numbers based on the auctioning volumes reported in the Auctioning Regulation (Commission Regulation (EU) No 1031/2010) and 2017/2018 auctioning data from EEX and ICE.

channel funding towards increased sustainability of energy sectors, there are still large loopholes for countries to fund emission-intensive electricity generation.

The Article 10c Derogation should explicitly exclude the possibility of fossil fueled generation and infrastructure receiving state aid. In addition, 'decarbonization' should be added as an explicit objective and criteria of this state aid in paragraphs 37 and 42(b).

On paragraph 38, capacity should be decommissioned by the operator itself, not by an 'associated operator', as this term is undefined. It would also be useful if the 'highest emission intensity' capacity is decommissioned, not 'higher emission intensity' capacity. The current wording allows for operators to decommission capacity based on operational decisions, not based on climate change objectives.

4. Conclusions

Indirect cost compensation is not an effective or necessary use of taxpayer money and should be scrapped. If it were to continue, however, it must have some positive climate impact. In this sense, the draft guidelines are a significant improvement with regards to the guidelines for 2013-2020 - especially with the conditions placed upon industry before they can receive state aid.

However, there is still a long way to go. The state aid guidelines for indirect costs especially should be improved in number of ways:

- a) Key variables should be defined correctly and less generously, especially the EUA price level and the maximum regional CO₂ factors need to be brought closer to reality. If real output levels can be used, then **real EUA prices** should also be a possibility. The **CO₂ factors on the other hand should look at all electricity generating capacity**, not just fossil fueled generation. Renewable energy and storage should be central in the calculation as they will dominate the EU energy mix by 2030. **Regional CO₂ factors and electricity consumption efficiency benchmarks** should be set in **line with reality and the EUs decarbonization strategy** and trends.
- b) Key **variables should be updated more frequently and automatically**. The **CO₂ factors and energy efficiency benchmarks** need to be sharpened annually, and the methodologies used to set them should be revised mid-term.
- c) **More transparency** throughout the designing, implementation and running of the schemes is necessary - we are talking about funneling taxpayer money to industry, and therefore a high level of transparency is vital to maintain trust and accountability.
- d) It is unacceptable to re-include eligible sectors based on intransparent and undefined criteria afterwards. **The qualitative assessment for sector eligibility must be dropped.**
- e) A **1.5% of GVA limit should be added as a criteria to the quantitative assessment** for sectoral eligibility.
- f) **We need clarity on the effectiveness of the scheme**, and its impacts on the internal market. The Commission does indicate that an Impact Assessment is underway to assess various options for the state aid, but will this be ready on time to feed into the ongoing public discussion?
- g) **Compensation should be delinked from ETS revenues**, and it needs to be made explicit that it does not count towards country use of revenues for climate and energy purposes (Article 10(3) of the EU ETS Directive)
- h) A **sunset clause and degressive aid intensity** should be included as an effective way to ensure indirect cost compensation is phased out over time.
- i) The **Art 10c derogation needs to explicitly exclude all fossil fueled generation and infrastructure** from funding.