

Public consultation on draft ETS State aid Guidelines

Reference HT.582

IFIEC – Europe answer

IFIEC-Europe welcomes the European Commission's public consultation on the draft guidelines regarding the compensation of indirect costs of the EU ETS for the period 2021-2030

Directive 2003/87/EC of the European Parliament and of the Council established a system for greenhouse gas emission allowance trading within the Union, in order to promote reductions of greenhouse gas emissions in a cost-effective and economically efficient manner. According to Article 10a(6) of the ETS Directive 2018/410, significant indirect ETS costs should be compensated by Member States in order to prevent the risk of carbon leakage that would lead to an increase of global greenhouse gas emissions if production is shifted outside Europe.

The CO₂ emissions costs passed on in electricity prices severely impact the competitiveness of the European industry, thus increasing the risk of carbon leakage. This is a cost which industries outside Europe do not face, and it exposes Europe to an increase of its carbon footprint due to the imports of products from countries with lower ambition for emission reduction.

In order to protect European industries from carbon leakage, IFIEC-Europe recommends:

- All industrial sectors exposed to a genuine risk of carbon leakage due to high exposure to international trade and/or significant indirect ETS costs may be eligible for compensation;
- With electrification being seen as a key technological pathway towards a low-carbon energy-intensive industry, the possibility to include in the list new sectors or sub-sectors, during the period 2021-2030 shall be foreseen;
- An aid intensity capped at 75 % might not be sufficient to ensure an adequate carbon leakage protection. Due to CO₂ price increase, European industry's exposure to carbon leakage is on a constant rise. Thus, IFIEC strongly supports the introduction of the new possibility for Member States to further limit the amount of the indirect costs to be paid at undertaking level to a percentage of the GVA of the concerned undertakings, which may reasonably be defined at 0.5%.
- The CO₂ emission factor should be set per geographic area which encompasses several EU Member States whose electricity markets are coupled. We do not support shrinking geographical areas. This is in contradiction to actual market developments and the aim of the electricity market Directive. It should be at least the same regions as in current legislation, taking into account that the New Market Design spurs market integration in the coming years.
- We disagree on conditional based compensation given our electro-intensive nature and the fact that we compete globally based on electricity cost. The European industry has and always had the strongest inherent incentive to be as energy efficient as possible. If such conditions are introduced to receive financial compensation, the conditions shall be set in a realistic and pragmatic way;
- We disagree that electricity consumption efficiency benchmarks should be linked to the ETS article 10a (2) as an arbitrary yearly decrease will not be based on real data. It

would result in an arbitrary reduction of the level of compensation, leading to the risk of insufficient protection against the risk of carbon leakage.

- Indirect ETS cost compensation should ensure a level playing field between outsourced and insourced industrial activities in order not to compromise the efficiency of many industrial processes and facilities.

Indirect CO₂ costs compensation is an essential carbon leakage protection measure for European industries. Such a mechanism will reduce the risk of relocations out of Europe and contribute to maintain and develop a high-performance and competitive industry in Europe that will make it possible to bring out, implement and export the solutions of tomorrow to reduce GHG emissions worldwide.

Eligible sectors

The list of sectors eligible to compensation of indirect CO₂ costs for the EU ETS phase IV proposed by the European Commission is too restricted. For the next EU ETS period, the new list should include at least the sectors currently eligible, due to the fact that these sectors will soon apply electricity-based technologies, whilst the risk of carbon leakage is increasing with rising prices for European Union Allowances (EUA). An additional qualitative assessment should be done to determine whether further sectors are at risk of carbon leakage. This assessment should be conducted either at a 4-digit level (NACE-4 code) or at an 8-digit level (Prodcom). The criteria to apply to determine whether a sector **or a sub-sector** is exposed or not to a risk of carbon leakage due to indirect CO₂ costs should be set in article 10b of the revised ETS Directive. The two additional criteria (trade intensity higher than 20 % and indirect emission intensity higher than 1 kgCO₂/EUR) set by the Commission in Annex I of the draft guidelines on State aid measures are not of the same logic as for direct emissions and should therefore not be applied. Moreover the “Assessment support study on ETS State Aid Guidelines” introduces a further quality criterion (RAG rating) not provided for the ETS Directive and not clear and transparent in definition and evaluation.

Due to imperfections in statistical data, it is important that sectors or sub-sectors not qualifying for the quantitative threshold should get the opportunity for a qualitative assessment. Sectors or sub-sectors, for which indirect carbon leakage indicator exceeds 0.15 should be included in the eligible list on the basis of a qualitative assessment. This qualitative assessment should be based on a transparent, structured approach similar to the logic applied in phase III. Therefore trade intensity and the fuel and electricity exchangeability are important elements to consider in the qualitative assessment. . The presence of a Sector or sub-sector in the EEAG Annex 3 list should be considered as an element of eligibility in order to have a consistent policy to limit risk of industrial activities relocation (and thereby carbon leakage).

The possibility to include in the list new sectors or sub-sectors, during the period 2021-2030 should be foreseen. As described above electrification is seen as a key technological pathway towards a low-carbon energy-intensive industry and potentially an important instrument to contribute to decarbonizing the energy system. After such a transition, with inter alia higher electricity consumption, some sectors or sub-sectors not eligible today would become exposed to carbon leakage. Not foreseeing this provision would hamper the decarbonation of industry by electrification and its potential contribution to a larger renewable share in the electricity mix.

CO₂ emission factor and geographical areas

- *Geographical areas*

Since the liberalization of the electricity market in Europe, transmission system operators have been investing in new interconnection capacities. Regional markets are more and more coupled. There is no reason to set a narrower zone as for the period 2013-2020.

The draft State Aid Guidelines propose a fragmentation of the current Guidelines' power market regions. The justification is an assessment in a report accompanying the draft Guidelines that price convergence in the Central and Western Europe (CWE) and Nordic zones has decreased. This is hard to follow and contradicts our own internal analysis. Indeed, cross-border interconnector capacity has consistently increased in the last ten years, and the improved physical connection is amplified by an increased use of flow-based market coupling. An empirical examination of day-ahead power prices shows more price convergence and correlation, not less, in most countries.

The best metric for measuring price homogeneity is not the absolute price difference between the markets, but the covariance between them. The reason for this is that two neighboring markets are often structurally different and thus have a fundamentally different price level. This can, for instance, be due to different generation sources. Further market improvement measures as planned and pushed by electricity legislation and further investments in transmission capacity will alleviate structural price differences and further improve market coupling (covariance). Such markets will not have equal prices until the transmission capacity between them is not a limiting factor and all bottlenecks are removed. This is not economically viable as it would require excessive investments in transmission capacity and it is also not the case internally in countries, where there are many bottlenecks at any time, but the price is kept equal through interventions in the power market.

This is also confirmed in the Report from the Commission and the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions - Energy prices and costs in Europe¹ -: "In the wholesale electricity market, increasing market coupling and interconnectors are clearly creating price convergence (an indication of more efficient markets), except during extreme price spikes and troughs when local supply differences are too great to be bridged across Member States." and "First, the creation of the single market helps to protect the EU from volatile prices affecting an individual Member State. With interconnections, (...), coupled markets and dynamic pricing, flexibility and growing trade between Member States provide a buffer against international price spikes. The broadly growing convergence in prices across Member States suggests that these efforts are bearing fruit."

As there is no price intervention to equalize the price between countries, there will occasionally be some price differences even between similar and well-connected markets since transmission capacity is not unlimited all the time. The most accurate metric for integration between power markets is an indication of how much they affect each other, i.e. evaluating how prices correlate. This measures how the price in one market influences the price in another and thus also to which extent the CO₂ element in one country spills over to another.

The most accurate way to measure market and price homogeneity between markets is by using power market models. Several analysts apply sophisticated power market models covering all of Europe and adjacent regions. These models not only identify price convergence, they also accurately identify actual carbon pass-through factors.

¹ SWD(2019) 1 final

➤ *CO₂ emission factor*

The Commissions recommended pass-through factor methodology based on fossil power generation emissions over fossil-based power generation may well be appropriate for power markets dominated by coal- or gas-fired plants. For countries where fossil-free power generation makes up a very large share, it is inaccurate.

The best way to identify which pass-through factor to use in the Nordics or in Central West Europe area is to apply power market models that accurately simulate the complicated hydro-nuclear-thermal interplay that is the connectivity between the Nordics and the Continent and France and its neighbouring countries. Such power market models exist, and are frequently used in numerous power market studies both in the Nordics and by the EU Commission (eg the DG Energy market models).

Maximum aid intensity

Indirect cost compensation in its current state has mitigated, but not removed, the risk of carbon leakage. To enhance low carbon investments as well as electrification of industrial processes and avoid carbon leakage, legal certainty on indirect CO₂ costs compensation should be ensured at least over the phase 4 of EU-ETS. Incomplete compensation is not effective.

- A stable aid intensity capped at 75 % might not be sufficient to ensure an adequate carbon leakage protection. Due to CO₂ price increase, European industry's exposure to carbon leakage is on a constant rise. Thus, IFIEC strongly supports the introduction of the new possibility for Member States to further limit the amount of the indirect costs to be paid at undertaking level to a percentage of the GVA of the concerned undertakings, which may reasonably be defined at 0.5%.

To be consistent with carbon leakage protection against direct costs, it is important that the aid intensity remains stable throughout the period.

Conditional based compensation not reflecting a genuine carbon leakage protection

Concerning paragraphs (53) and (54a): Energy efficiency is key to achieving greenhouse gas reductions within the European Union. It has contributed in the mitigation of greenhouse gases emissions linked to the industry' energy consumption in Europe for decades. However, the subsequent and additional criteria proposed by the Commission are mixing legislation on implementation of EED requirements and ETS carbon leakage protection.. They also do not consider past investments and efforts from the industry. Industrial facilities that have already implemented the best available technologies that have invested a lot in energy efficiency and/or have a very low indirect carbon footprint should be able to benefit from the compensation of indirect costs. Otherwise, the guideline would favor the least performing facilities, whose potential for energy efficiency is far greater. Carbon compensation is an essential competitiveness measure for European industries.

Concerning paragraph (54b): Given the huge amounts of electricity that are needed for the electro-intensive industry, stipulating that 50% of this energy should come through an "on-site renewable energy generation facility" is not even technically feasible.

Concerning paragraph (54c) the objective of indirect compensation is to reduce the risk of carbon leakage due to the increased electricity prices brought about by the EU ETS. Using a

major part, up to 80% of indirect compensation to address direct emissions, is not in line with this objective. Incentives to reduce direct emissions should not be included in this piece of legislation but in other legislation (ETS Directive).

For these reasons, IFIEC-Europe urges the Commission to delete the whole paragraph (54). The proposed approach is not relevant and not adapted to the diversity of the situations of the industrial facilities.