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EU carbon market state aid rules moving in the right direction - but not far enough

New EU state aid guidelines for compensating industry for higher electricity costs under the EU carbon market reduce the number of eligible sectors and limits aid to those investing in energy efficiency. However, if this so far inefficient and expensive scheme is to continue, further significant improvements are needed to ensure that it helps Europe become carbon neutral.

To reflect the latest revision of the EU Emissions Trading System (EU ETS), the European Commission has proposed updated state aid guidelines related to the EU ETS. The guidelines set, among other things, the conditions under which EU member states can compensate their electricity-intensive industries deemed at risk of 'carbon leakage' for potentially increased electricity prices due to power companies needing to buy emission allowances. These are called "indirect costs".

Carbon leakage refers to a hypothetical situation where production is moved to other parts of the world with laxer environmental regulation. However, as a study released by the European Commission admits, there is actually no evidence of carbon leakage due to indirect costs.[1]

The scheme has until now been very generous, with massive payouts of taxpayer money to the industry without any climate co-benefits. Over 2017-2018 alone, nearly 1,2 billion Euros[2] were given to industry, and this number is set to rise in step with the EU carbon price.

While the draft guidelines for 2021-2030 have improved substantially compared to those in place for 2013-2020, there is still a long way to go.

The good news...

The complex formula that defines the size of the payouts has been refined and somewhat improved. First, some key variables would be brought closer to reality, and could finally be updated over time instead of being set in stone for 10 years - for example, real production levels of factories would be used instead of historic production to calculate the size of the subsidies.

[1] https://ec.europa.eu/competition/consultations/2020_ets_stateaid_guidelines/consultance_report.pdf

[2] European Commission Report on the functioning of the European carbon market (2018 and 2019 iterations)

Second, the number of eligible sectors has been reduced from 13 sectors and 7 sub-sectors to just 8 sectors (though the door has been left open for another four sectors to be added through an intransparent 'qualitative assessment').

Finally, and most importantly, changes have been introduced to ensure that only companies investing in either energy efficiency, renewable energy (production or purchasing) or reducing emissions can receive state aid. However, the rules do not require that these investments be additional - i.e. that the company wouldn't have done them in the absence of the state aid scheme. Such additionality criteria should be added to the rules so that the state aid scheme would finally bring some environmental benefits.

...now for the bad news

There are still some large and unresolved problems that undermine the logic for using public funds for this state aid scheme.

Most importantly, as mentioned above, there is no proof of carbon leakage due to indirect costs - meaning there is actually no need for these subsidies. Industrial greenhouse gas pollution has not decreased the last 8 years[3], and indirect cost compensation together with free pollution subsidies could even be slowing down climate action by taking away any incentive for the industry to clean up its act.

Many of the potentially eligible factories don't buy any electricity from the grid but produce it on site. These installations would receive indirect cost compensation for the 'opportunity cost' of not selling their electricity to the grid - this is an unacceptably ineffective use of taxpayer money.

The EU has no comparable scheme to support citizens for higher energy costs due to climate change policy. 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.

The draft rules would allow governments to potentially give up to 25% of their EU ETS auctioning revenues back to their industries. This is unacceptable - revenues from selling pollution permits should be used 100% to finance the transition to carbon neutrality in order to benefit society as a whole.

Some variables in the draft rules need to be tightened, both by setting the starting point for 2021 less generously and by updating them annually and automatically. These variables include the product-benchmarks for energy efficiency and the regionally set embedded emissions in electricity. Finally, the draft rules should push for far more transparency. Critical data on which company receives how much should be made publically available. A "qualitative assessment" that might make more

[3] Cracking Europe's hardest climate nut – How to kick-start the zero-carbon transition of energy-intensive industries?

sectors eligible is mentioned but not explained, and some key elements of the proposal have been left blank.

Avoiding fossil fuel investments through the EU ETS

A second state aid scheme that is covered by these guidelines is the 'transitional free allocation for the modernisation of the energy sector' (also known as the Article 10c derogation). This exemption in the EU ETS allows Central and Eastern European countries to give free pollution permits to their power sector although in the rest of the EU, the power sector has to buy them since 2013.

There is an urgent need to phase out all - especially public - funding for CO2 polluting power capacity to avoid carbon lock-in and this scheme should include an explicit exclusion of all fossil-fueled generation for funding.

Conclusions

Using taxpayer money for indirect cost compensation is not acceptable. However, if it is done, it should at least have climate benefits. While the Commission's draft guidelines take steps in the right direction, they are nowhere near strong enough to ensure that this is the case.

If this inefficient and expensive scheme is to continue, it should at least:

1. Push for investments in energy efficiency, renewable energy and emission reductions. Therefore the conditions for receiving subsidies should be significantly strengthened.
2. Not be linked to EU ETS revenues. These should be spent on promoting the transition to a zero-carbon society.
3. Be less generous, with a limited number of sectors covered and self-generated electricity excluded. The calculations on how much installations get in handouts should be based on increasingly tightened variables to phase out state aid over time.

Heavy industry can and must decarbonise if the EU is to achieve its climate neutrality goal. Governments need to stop wasting taxpayer money in inefficient schemes that do nothing but postpone the inevitable change which only becomes more difficult the longer we wait. A proper price tag on pollution incentivizes industry to innovate and become cleaner. This is the only way to ensure that our industry remains competitive and will continue to provide good jobs in Europe.

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Public consultation on the draft rules is open until March 10th 2020. Carbon Market Watch's detailed response will be available on our website soon.