Explanatory note accompanying the proposal for the revision of the Emission Trading System Guidelines[1]

On 20 December 2018 the Commission has published an Inception Impact Assessment to inform citizens and stakeholders about the initiative to revise the Guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading system ("ETS Guidelines"). The purpose of this note is to clarify the objective and scope of the proposal for the revision of the Guidelines. The note accompanies the public consultation on this proposal.

Citizens and stakeholders are invited to provide views on the Commission's proposal and its possible impact on the risk of carbon leakage, on the effectiveness of the ETS system, as well as on possible distortions of competition. This public consultation lasts for eight weeks. In addition, as already announced in the Inception Impact Assessment, a meeting with the Member States will be held to gather their feedback on the draft Guidelines proposed for consultation.

1. Context

Directive 2003/87/EC ("ETS Directive") introduced in 2005 a cap and trade system aiming at reducing CO_2 emissions in the EU in a cost-effective way. This directive has been subject to several modifications, the last of which dating from 2018 (Directive (EU) 2018/410). Companies covered by ETS have to buy CO_2 certificates corresponding to their own industrial emissions (direct ETS costs). Consequently, companies may also pay more for the electricity they consume ("indirect ETS costs") as electricity producers pass the carbon price on to consumers via the electricity price.

According to Article 10a(6) of the ETS Directive as amended, indirect ETS costs can be compensated by Member States in order to address the so-called "carbon leakage risk" related to the EU ETS.

On 11 December 2019, the Commission published the European Green Deal Communication, outlining the policies to achieve climate-neutrality in Europe by 2050. To deliver the European Green Deal, there is a need to rethink policies for clean energy supply across the economy, industry, production and consumption, large-scale infrastructure, transport, food and agriculture, construction, taxation and social benefits. While all of these areas for action are strongly interlinked and mutually reinforcing, careful attention will have to be paid when there are potential trade-offs between economic, environmental and social objectives. By summer 2020, the Commission will present an impact assessed plan to increase the EU's greenhouse gas emission reductions target for 2030 to at least 50% and towards 55% compared with 1990 levels in a responsible way. To deliver these additional greenhouse gas emissions reductions, the Commission will, by June 2021, review and propose to revise where necessary, all relevant climate-related policy instruments. These policy reforms will help to ensure effective carbon pricing throughout the economy. This will encourage changes in consumer and business behaviour, and facilitate an increase in sustainable public and private investment.

As long as many international partners do not share the same ambition as the EU, there is a risk of carbon leakage, either because production is transferred from the EU to other countries with lower ambition for emission reduction, or because EU products are replaced by more carbon-intensive imports. If this risk materialises, there will be no reduction in global emissions, and this will frustrate the efforts of the EU and its industries to meet the global climate objectives of the Paris Agreement.

Addressing the risk of carbon leakage complements those policies and serves an environmental objective, since the aid aims to avoid an increase in global greenhouse gas emissions due to shifts of

[1] OJ C 158, 5.6.2012, p. 4–22

production outside the Union, in the absence of a binding international agreement on reduction of greenhouse gas emissions. At the same time, aid for indirect emission costs may have a negative impact on the efficiency of the EU ETS. If poorly targeted, the aid would relieve the beneficiaries of the cost of their indirect emissions, thereby limiting incentives for emission reductions and innovation in the sector. As a result, the costs of reducing emissions would have to be borne mainly by other sectors of the economy. Furthermore, such State aid may result in significant distortions of competition in the internal market, in particular whenever undertakings in the same sector are treated differently in different Member States due to different budgetary constraints. Therefore, the draft Guidelines proposed for consultation need to address three specific objectives: minimising the risk of carbon leakage, preserving the EU ETS objective to achieve cost-efficient decarbonisation and minimising competition distortions in the internal market. Once the draft Guidelines are adopted, the Commission will make sure that they remain consistent with, and contribute to, all relevant climate-related policy instruments that will be proposed in the context of the Green Deal to ensure effective carbon pricing throughout the economy, while respecting a level playing field.

According to Article 10c of the ETS Directive, Member States fulfilling certain conditions relating to the level of GDP per capita in comparison to the Union average, may derogate from the principle set under Article 10a(1) of the ETS Directive that no free allocation shall be made in respect of any electricity production. These Member States may give a transitional free allocation to installations for electricity generation for the modernisation, diversification and sustainable transformation of the energy sector.

As the compensation of indirect ETS costs under Article 10a(6) and the allocation of free allowances under Article 10c of the ETS Directive constitute State aid within the meaning of Article 107 TFEU these measures can only be put in place once the Commissions has declared them compatible with the internal market pursuant to Articles 107 (2) and (3) TFEU. The ETS Guidelines set out the Commission's requirements when deciding on the compatibility of these measures.

The current ETS Guidelines date from 2012 and will expire on 31 December 2020. Therefore, they have to be revised for the next trading period of the ETS (2021-2030).

For the purpose of the revision of the ETS Guidelines, the Commission has collected data through a public consultation followed by a targeted consultation in 2019. Based on the results of these consultations, the Commission has conducted an evaluation of the current guidelines. On this basis as supplemented with the feedbacks that will be received from the present public consultation, the Commission is elaborating an impact assessment of the different options for the revision.

2. Indirect Cost Compensation

The purpose of the draft Guidelines proposed for consultation is to address the risk of carbon leakage due to indirect ETS costs while minimizing competition distortions and maintaining the incentives for a cost-effective decarbonisation of the economy. The draft Guidelines proposed for consultation take into account the new provisions of the revised ETS Directive, the evolution of market conditions and the previous practices of Member States.

This section provides an overview of the main changes the Commission considers at this stage of the revision process. The Commission stresses that the text of draft Guidelines proposed for consultation is not definitive and will be reassessed in light of the feedback and evidence received from the present public consultation.

2.1. *Eligible sectors*

First, compared to 2012 ETS Guidelines, the proposal provides an updated and more limited list of sectors eligible for compensation. This list includes eight sectors, which have been identified as the sectors most exposed to an actual risk of carbon leakage.

The methodology used to establish the list of eligible sectors relies on the carbon leakage indicator as defined in Article 10b of the revised ETS Directive, calculated based on indirect cost only. The indirect carbon leakage indicator required for eligibility is 0.2. In addition, eligible sectors need to have a trade intensity of at least 20% and an indirect emission intensity of at least 1 $kgCO_2/EUR$. These values are calculated at NACE code 4 level using the dataset also used for establishing the Carbon Leakage List used for the allocation of free ETS allowances.

Those quantitative criteria have been designed on the basis of a study assessing the impact of indirect ETS costs on selected sectors in the next trading period. This study is also published to accompany the consultation on the draft Guidelines.

The Commission may decide to include additional sectors, in light of the feedback and evidence received in the public consultation, based on qualitative considerations provided the sectors concerned have at least an indirect carbon leakage indicator of 0.2 and that their carbon leakage risk as evaluated by the consultant in the study is at least medium.

2.2. *Aid intensity and degressivity*

The draft Guidelines proposed for consultation also establish the aid intensity, i.e. the maximum share of indirect ETS costs that Member States can compensate. The proposal maintains this aid intensity at 75%. This value is in line with the aid intensity applied at the end of the third ETS trading period under the previous guidelines.

The draft Guidelines proposed for consultation also introduce the possibility for Member States to further limit the exposure of beneficiaries to indirect ETS cost as a function of their gross value added ("GVA"). This new possibility is aimed at limiting the exposure to indirect ETS cost of certain sectors for whom these costs, even after applying the 75% compensation, can make up a disproportionate amount of their GVA. Stakeholders are invited to present their views on this new possibility.

Contrarily to what it provided for under the 2012 ETS Guidelines, the aid intensity would not be degressive but stable throughout the entire ETS trading period. Instead the Commission will conduct a mid-term update of the electricity consumption efficiency benchmarks, based on the most electricity-efficient methods of production for the product considered, to take into account most recent data and production processes. The Commission considers that this update of the efficiency benchmarks is better suited to capture any potential efficiency gains in the sectors concerned than a per-se reduction of the aid intensity.

The Commission is considering aligning the methodology for updating the electricity consumption efficiency benchmarks for the purposes of these Guidelines with the methodology specified in Article 10a(2) of the EU ETS Directive (see point 14(13) of the draft Guidelines proposed for consultation). Under this methodology, the Commission would extrapolate an annual reduction rate for each benchmark based on past efficiency improvements. Stakeholders are invited to present their views on the use of such methodology in the future Guidelines.

Member States should amend, where necessary, their respective schemes in order to bring them into line of these updates.

2.3. *Aid amount calculation formula*

Third, the estimated amount of indirect ETS costs and consequently the maximum aid amount would be calculated on the basis of parameters comparable to those used under the 2012 ETS Guidelines.

- Differentiated regional "CO_2 emission factors", which reflect the CO_2 intensity of electricity produced from fossils fuels in a given geographic area, will continue to apply. For this purpose, the relevant geographic zones have been defined according to the same methodology as was used under 2012 ETS Guidelines, i.e. the development of market coupling and the degree of actual price convergence, using updated economic data.

- The baseline output used for the purposes of the calculation corresponds to the actual production in the year preceding the granting of the aid. The impact assessment of the 2012 ETS Guidelines stated that such option would risk undoing the price signals and incentives from the ETS to become more efficient in terms of electricity consumption. However, as compensation of indirect ETS costs is only a partial compensation, an increase of production leading to an increase of electricity consumption will always result into increased electricity costs for the undertaking. Therefore, the Commission considers that the reliance on actual output figures most accurately reflects the level of indirect cost incurred by each beneficiary and maintains the incentive for energy efficiency. On the contrary, as the historical output does not allow to calculate the actual indirect costs faced by an individual undertaking, it does not fully maintain the incentive for the undertaking to become more efficient. Indeed, in a situation where the historical output value is higher than the actual output, using the historical output as the reference parameter would reduce the price signal from the ETS and therefore undermine the incentive to improve energy efficiency.

- The electricity consumption efficiency benchmarks, which represent the product-specific electricity consumption per tonne of output achieved by the most electricity-efficient methods of production for the product considered, will be updated at the beginning of the next ETS trading period. They will also be updated once in the middle of the next trading period.

- The aid amount calculation would continue to include the average of the daily one-year forward EU allowances price.

Several parameters used to calculate the aid amounts have not been set in the attached draft Guidelines proposed for consultation and will be established at a later stage. This concerns the electricity consumption efficiency benchmarks, the actual level of the above GVA cap and the actual regional CO_2 factors. The CO_2 emissions factors will be set on the basis of the most recent Eurostat data (2019), and will be updated once in the middle of the next trading period. In 2025, the Commission will also assess whether additional data is available allowing to improve and revise the methodology used to calculate the CO_2 emission factors, i.e. to take into account the increasingly important price-setting role of low-carbon technologies in EU electricity markets.

2.4. *Conditionality*

Finally, the draft Guidelines proposed for consultation propose to strengthen the conditionality of the compensation of indirect ETS costs by going beyond the obligations already set by the Energy Efficiency Directive 2012/27/EU. Stakeholders are invited to present their views on this new conditionality requirement. Member States would have to verify that beneficiaries, irrespective of their size, have conducted or commit to conduct an energy audit or have an energy or environmental management system[2] in place. Member States would also have to monitor the implementation of the resulting recommendations by large undertakings. Member States would have to monitor compliance with this requirement. Also, the Commission as part of its monitoring efforts for approved schemes can check compliance with this requirement.

3. Modernisation of Electricity Generation

The new provisions related to aid involved in optional transitional free allowances for the modernisation of electricity generation are largely pre-determined by Article 10c of the revised ETS Directive. The objective of this type of aid is the modernisation, diversification and sustainable transformation of the energy sector. For projects involving a total amount of investment exceeding EUR 12,5 million, aid would be granted on the basis of a competitive bidding process which complies with the requirements of the draft Guidelines proposed for consultation. For projects below EUR 12,5 million, State aid measures would also be subject to State aid assessment.

4. Measures not covered in the draft Guidelines proposed for consultation

Since no Member State has implemented certain categories of aid provided for in the 2012 ETS Guidelines, namely aid involved in the exclusion of small installations and hospitals from the EU ETS, the Commission has removed the relevant provisions from its proposal. Should Member States decide to implement such measures going forward, the Commission will analyse them directly under the TFEU.

The draft Guidelines proposed for consultation also do not apply to State aid granted to investments to modernise energy system and proving energy efficiency through the Modernisation Fund established by Article 10d of the ETS Directive.

[2] For example, Regulation (EC) No 1221/2009 on the voluntary participation by organisations in a Community eco-management and audit scheme (EMAS), OJ L 342, 22.12.2009, p. 1–4.