State aid for biofuels (1)

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Community policy encourages biofuels

The promotion of biofuels and other renewable fuels to replace diesel or petrol for transport is a well established Community priority, as biofuels are expected to contribute to objectives such as the reduction of CO2-emissions and environmentally friendly security of supply. Most concretely, Article 3 of Directive 2003/30/EC of the European Parliament and of the Council of 8 May 2003 on the promotion of the use of biofuels or other renewable fuels for transport (2) (hereinafter ‘the Biofuel Directive’) establishes a reference value of 5.75% of all petrol and diesel for transport purposes placed on their markets by 31 December 2010. Recently, the Commission adopted two further communications concerning biofuels, namely the ‘Biomass action plan’ of 7 December 2005 and ‘An EU strategy for biofuels’ of 8 February 2006 (3). The environmental benefits of biofuels depend to a significant extent on the use of energy and non-renewable resources in their production and the cultivation of the feedstocks.

Measures to encourage biofuels normally constitute State aid in the meaning of Article 87(1) of the Treaty, and by now the Commission has adopted a dozen of decisions not raising objections to such aid. The more recent decisions on the Czech, Dutch and Swedish measures may serve best as reference documents (4). This article addresses some of the less obvious aspects of the State aid assessment, notably the State aid nature of general tax exemptions, the rule to avoid overcompensation, the relation with other applicable Community legislation, the alternative instrument of biofuel supply obligations and the assessment of less common biofuels.

General exemptions for biofuels constitute State aid

First, in the case of a general exemption from the fuel tax, the existence of State aid is not always clear to everyone. In the case of tax exemptions granted only to a limited number of biofuel producers, typically selected by means of a tender procedure, the selective nature is clear. But in the case of general tax exemptions for biofuels it could be argued that the direct benefit would go to the consumer and that any producer of biofuel is free to compete in the market. The Commission, however, has consistently held that such tax exemptions, despite applying generally to all biofuel sales, favour selectively the production of biofuels and distort competition vis-à-vis other fuels.

Pure vegetable oils like rape oil are included in annex I of the Treaty, and hence the Community guidelines on State aid in the Agricultural sector (5), section 5.5.3, apply. For other fuels, the compatibility criteria can be found in the Community guidelines for State aid for environmental protection (6), section E.3.3. Both sets of rules allow basically the same aid amounts. The latter text allows different options for Member States as to how to support renewable energy. Normally, option 1 (points 58-60) is applicable, which means that operating aid can be granted in order to cover the difference between the cost of biofuel production and its market price. The starting point for determining the market price is typically the price of the fossil fuel for which the biofuel substitutes. Consumers may, however, take into account the lower energy content of biofuels and therefore be prepared to buy biofuels only if their market price is correspondingly lower (7). Biofuels are normally produced from biomass, and therefore there is no need to limit the aid to the higher investment cost only (point 60).

Avoiding overcompensation

‘Allowing aid only to cover the difference between cost and market price’ is equivalent to ‘there should be no overcompensation for biofuel producers’. In

(1) The content of this article does not necessarily reflect the official position of the European Communities. Responsibility for the information and views expressed lies entirely with the authors.
(2) OJ L 123, 17.5.2003, p. 42.
(4) Cases N223/05 CZ, N570/05 NL and N112/04 SE. The decisions in English can be found on http://europa.eu.int/comm/competition/state_aid/decisions/additional_docs.html.
(6) OJ C37 of 3.2.2001, p. 3.
(7) Energy content values can be found in the report ‘Stationary Applications of Liquid Biofuels’: http://europa.eu.int/comm/energy/res/sectors/doc/bioenergy/pta_biodiesel_final_rev2_1.pdf. With low blends, however, the effect might be less noticeable to the consumer or not noticeable at all. In some cases, the Commission accepted energy content values given in studies that address the particular situation (e.g. type of cars) in the Member State concerned.
practice, this is not so easy: cost of production depends on many factors, e.g. type of fuel, type of raw material, scale of production, market price for by-products, etc. There are many cost studies, but they do not appear to cover all situations brought forward by Member States. Until now, the Commission generally was able to rely on the information provided by the Member State, though sometimes only after some critical discussion.

General tax exemptions allow aid that may just suffice to compensate for the extra costs of domestic producers, but at the same time may make it attractive to import cheaper biofuels from third countries. Under the current market conditions, this situation typically arises for ethanol produced from cane. Bioethanol can be imported under various customs codes, and some Member States exempt imported fuels from the tax only when they are imported under the code with the highest customs duty. Biofuel imports should not merely be considered as a problem, but rather as part of the solution. The European biofuel strategy cannot be based on domestic production only, and in its most recent communication, the Commission calls for a balanced trade strategy. Also from the competition point of view, the issue may not be very problematic, since an aid that is available to any biofuel producer does not distort competition between different biofuel producers. Differences in competitive strength are inevitable in any market where producers of similar products use different feedstock with different production technologies. General tax exemptions do not affect such differences, but preserve competition between biofuel producers.

Cumulation of tax exemptions and direct operating grants is no problem provided that the combined aid level does not lead to overcompensation. Cumulation of operating aid and regional investment aid may not pose a problem, as regional aid is supposed to compensate for the disadvantages from carrying out an activity in a less developed region. But in certain situations, it may well be appropriate to take the effect of investment aid into account when calculating the level of operating aid that can be granted without leading to overcompensation. This would be the case in particular when operating aid is cumulated with environmental investment aid, which is granted for the very same purposes.

There are also a number of practical issues when it comes to avoiding overcompensation: on which prices for fossil fuels, on which exchange rates and on which time series should the aid be based? The Commission has not developed rules for this, but in general simply requests that the methods used are reasonable. Monitoring and adaptation of the aid level if necessary for avoiding overcompensation, should take place at least once a year. The Czech authorities set a laudable example by having a more frequent revision for its biodiesel scheme, but this may not be possible in different administrative contexts.

Respecting other relevant Community legislation

A number of conditions for aid derive from other relevant Community legislation, notably Directive 2001/77/EC of the European Parliament and the Council of 27 September 2001 on the promotion of electricity produced from renewable energy sources in the internal market (9) as regards the definition of ‘renewable energy’ and Council Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity (10) (hereinafter the ’Energy Tax Directive’), in particular Article 16, as regards tax aspects. This Directive requires, among other things, that tax exemptions are limited to the biofuel part in the blended fuel and that exemptions granted to individual companies have a maximum duration of only 6 years. Of course, Community tax law prohibits discrimination between domestic and imported products. When using direct subsidies to producers, such discrimination is not a problem: it is rather inherent in the notion of State aid. What is not allowed, however, is granting aid conditional upon the use of domestic raw material. This directly breaches WTO-provisions.

Biofuel supply obligations

Some Member States (e.g. Austria, the UK, Germany and the Netherlands) have put in place or consider putting in place, biofuel supply obligations, i.e. legal obligations imposed on any fuel supplier to sell a minimum percentage of biofuels in its overall sales. In order to create flexibility, the system can be combined with tradable certificates. Supply obligations don’t involve State resources and hence they don’t involve State aid in the meaning of Article 87(1). In addition, as the extra costs can be expected to be reflected in fuel prices in general, such obligations shift the burden from tax payers to suppliers and consumers, which is more in line with the ‘polluter pays principle’. When applying in a general way, they may have the least distortive effect on competition and therefore, from a competition point of view, they seem attractive. A supply obligation may fully replace a tax exemption, but Austria, e.g., combines the instruments. Being aware of this, the Commission approved the Aus-

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trian tax exemption, as the aid was still justified by the difference between the production cost and the market price of the biofuel in the meaning of the current rules.

Less common fuels, future policy

There are some less common biofuels like biogas and hydrogen. Often, for such fuels Member States grant tax exemptions to pilot projects on the basis of Article 15(1) (a) of the Energy Tax Directive rather than a general tax exemption on the basis of Article 16. The Swedish case provides further details on the Commission's assessment of such fuels.

As a final remark, the Commission may make proposals as regards the instruments to be used for encouraging biofuels in the context of its mid-term review of the Biofuel Directive, which is planned for 2006. Of course, consequences for the Commission's assessment of State aid for biofuels can, at this stage, not be excluded.