

## EU ETS Indirect Compensation Consultation

### Introduction

The Emissions Trading System (ETS) is a cap and trade scheme focused on direct emissions in which allowances to emit CO<sub>2</sub> are strictly limited and are available to emitters either as a free allocation on a transitional basis or by auction.

The allocation of the transitional free allocation of allowances shall be made in accordance with Union-wide and fully-harmonized rules based on so-called 'ex-ante' benchmarks and activity levels, implying that allocations to incumbent installations must be fixed prior to the start of the third trading period in 2013.

*Benchmarks for the direct emissions associated with the production of hydrogen and syngas have been developed by EIGA and incorporated into the appropriate legislative measures. These benchmarks will be the basis for appropriate free allocation to hydrogen and syngas producers in the industrial gases sector and elsewhere.*

The ETS Directive also foresees that Member States may adopt financial support measures in favour of sectors determined to be exposed to a significant risk of carbon leakage due to their *indirect emissions* (i.e. increases in electricity prices resulting from the inclusion of the costs of greenhouse gas emissions from the power sector), subject to state aid rules.

*Benchmarks for the indirect emissions associated with the production of oxygen and nitrogen in both gaseous and liquid forms have been developed by EIGA, which should be the basis for financial compensation to be received by the industrial gases sector and other producers.*

The State aid measure is, to ensure that Member State interventions do not distort competition and trade inside the EU. In this respect, a financial compensation, which abides by the principle of equality of treatment between externalized and in-source production as recalled in the recital 23 of the ETS Directive, will prevent carbon leakage while keeping the economic efficiency and the environmental advantage of the externalization business model.

The use of *ex ante* benchmarks as the basis for both free allocations and any financial compensation is intended to ensure that these have no distortive effect on marginal operating decisions. It is a fundamental priority for the design of the ETS that negative effects in terms of distortions of competition in the internal market should be avoided.

However, distortions could still arise if features of the ETS system and any New State aid Guidelines in the context of the ETS which are not equivalent to an ex-ante approach and thus were to affect the strategic or operating decisions taken by the industrial gases sector or its customers. For example, if there were to be:

1. differences between the mechanism for calculation of support for direct emissions - in the form of free allocations - and the corresponding mechanism for calculation of support for *indirect* emissions – in the form of financial compensation;
2. differences between the compensation received by in-sourced and out-sourced installations.

Whilst differential treatment between such installations is to be avoided for ensuring a higher overall level of environmental protection such differences might arise in a subtle manner if, for example, there were to be an *implicit* benchmark for indirect emissions deriving from *in-sourced* oxygen or nitrogen included in a particular product benchmark and if that *implicit* benchmark were to be different from a dedicated *explicit* indirect emissions benchmark for oxygen or nitrogen produced in *out-sourced* installations.

### Executive Summary of EIGA's Position:

In order that distortions due to any compensation for indirect emissions be avoided whilst minimizing the threat of

carbon leakage and achieving the environmental goals set for the ETS, it is EIGA's belief that the best approach is that:

1. Compensation for indirect emissions should be considered for all exposed sectors and sub sectors as determined by the Commission in December 2009, including highly electricity intensive (sub) sectors as oxygen and nitrogen.
2. In case of financial compensation to a sector, there should be no distortion regarding state aid between in-sourced and externalized production of intermediate products such as oxygen and nitrogen. The principle of equality of treatment, already stated in Recital 23 of the ETS directive, should be explicitly included within the State Aid Guidelines for indirect emissions.
3. Any compensation for indirect emissions, including the highly electricity intensive oxygen and nitrogen sub-sectors, should be based exclusively on ex ante product benchmarks corresponding to the "best available technology."
4. Any production of oxygen or nitrogen should be explicitly excluded from "system boundaries" for products for which benchmarks were developed with consideration of exchangeability of fuel and electricity,

### Consultation:

A consultation has been launched by the European Commission on the future Guidelines for State aid in the context of the amended EU Emissions Trading Scheme, structured around the following sections:

- A. Eligible sectors for support for indirect emission costs & inability to pass-through increased emissions costs due to ETS-3
- B. Level of support, i.e. how to maintain an incentive to reduce electricity consumption and stimulate a shift in demand from "grey" to "green" electricity
- C. Benchmarks, i.e. how to set ex-ante benchmarks for indirect emissions per unit of production
- D. CO<sub>2</sub> emission factor, i.e. Which method of calculation shall be adopted to establish the level of financial compensation
- E. Other Issues

### Response:

Following the structure of the consultation, EIGA would like to present the following observations.

#### A. Eligible sectors for support for indirect emission costs & inability to pass-through increased emissions costs due to ETS-3

**A1 Key Message:** The consultation should include sectors (NACE 4) and sub sectors (PRODCOM 8) as mentioned in the directive.

The sub-sectors at PRODCOM 8 level represent some externalized industrial activities such as industrial gases production. Any failure to take these sub-sectors into account would be against the principle of equality of treatment between internalized and externalized installations, as stated in the recital 23<sup>1</sup> of the EU ETS:

The sub-sectors and the externalized production represented within those sub-sectors shall therefore be assessed for eligibility for financial compensation for indirect emissions through electricity prices, in the same way as they have been assessed during the establishment of the list of sectors exposed to carbon leakage.

**A2 Key Message:** The (sub) sectors eligible for state aid for indirect emission costs are the exposed sectors. There is no reason to review the previous European Commission analysis and the criteria (article 10.a.15 and 10.a.16). The exposed sub sectors **O<sub>2</sub> and N<sub>2</sub> production** are highly impacted by the indirect additional costs (costs/GVA>58%<sup>2</sup>) and should be considered for state aid regarding the costs of indirect emissions.

<sup>1</sup> "Transitional free allocation to installations should be provided for through harmonised Community-wide rules (ex-ante benchmarks) in order to minimise distortions of competition with the Community. [...] Furthermore, they should avoid undue distortions of competition between industrial activities carried out in installations operated by a single operator and production in out sourced installations."

<sup>2</sup> The derivation of this figure is according to the methodology provided by Price Waterhouse Coopers, and mandated by DG ENT to calculate the carbon intensity of the European Industrial sectors in 2009. It was presented under the heading 'EIGA PRESENTATION – SPECIFICITIES OF THE INDUSTRIAL GAS SECTOR' to Mrs. Tranholm-Schwarz, DG COMP, on 23.10.09.

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The list of exposed sectors and sub sectors established by the Commission in December 2009 should constitute the list of sectors and sub sectors entitled for state aid for indirect emissions. A more restrictive approach could create distortions amongst (sub)sectors, in particular for (sub)sectors relying on the externalization of production such as the industrial gases. Nevertheless, in the case that the European Commission chooses to restrict the scope of the list of sectors entitled for state aid, EIGA recommends the approach of selecting, from the list of exposed sectors, those which are the most impacted economically by the indirect emissions, that is the electro intensive industries with a ratio “indirect costs/gross value added” superior to 2 to 3%.

**A3 Key Message: Any distortion regarding state aid between “externalized” and “in-sourced” O<sub>2</sub> and N<sub>2</sub> production will result in a lower overall level of environmental protection (increase of greenhouse gas emissions) and reduce the economic and carbon efficiencies.**

An artificial distortion would be created between an Industrial Gas company and those of its customers exposed to “carbon-leakage” if the latter alone were compensated for higher costs related to indirect CO<sub>2</sub> emissions. Indeed, the industrial gas sector’s customers would experience a perverse financial incentive to “in-source” or “internalize” the production of the gases needed in their industrial processes. The consequences of this behaviour would be:

- (a) to reduce the economic and carbon efficiencies of the overall supply chain; and
- (b) to reduce the uptake of energy- and environmentally efficient industrial gas applications technologies developed by the Industrial Gases sector; and
- (c) to unfairly penalise the Industrial Gases sector itself; and
- (d) to increase costs to other sectors of industry that currently benefit from aggregation of their industrial gases requirements with those generally larger demands of sectors exposed to “carbon leakage”.

Crucially, it has been recognized in the Directive (‘Recital 23’) that these distortions will be avoided if the application of the mechanisms provided for by the Directive for the avoidance of “carbon leakage” does not discriminate between the “in sourced” and “out sourced” production of industrial gases.

**B. Level of support, i.e. How to maintain an incentive to reduce electricity consumption and stimulate a shift in demand from "grey" to "green" electricity**

The revised ETS Directive Article 10a6 allows Member States to adopt financial measures to compensate electro-intensive sectors for the additional costs of carbon passed through in electricity prices. The use of *ex ante* benchmarks for indirect emissions based on the best available technologies by sector ensures a strong incentive to improve electricity and carbon efficiencies in industrial installations. EIGA has presented indirect emissions benchmarks for nitrogen and oxygen.

**B1 Key Message:** The eligibility of the energy intensive sub sectors such as oxygen and nitrogen production, based on a electricity benchmark approach, will maintain the current incentive to select the most economic and green solution which is, very often, the externalization of the production for numerous industry sectors.

**C. Benchmarks, i.e. How to set ex-ante benchmarks for indirect emissions per unit of production**

To maintain fairness within incentives to reduce indirect emissions, it is necessary that any action reflect the range of current industry practice and performance to the fullest extent practicable. The identification of “exposed sectors” and the setting of *ex ante* benchmarks for the determination of free allocation for *direct* emissions responded to this requirement and provide a useful basis for designing equivalent action with respect to *indirect* emissions.

Specifically in the cases of sub-installations governed by prod

uct benchmarks defined such that allocation for direct emissions includes a correction for the exchangeability of fuel and electricity, the electricity which is eligible for compensation may be set at the same value as that correction.

Sub-installations producing oxygen and nitrogen do not normally involve direct emissions - and no product benchmarks have been determined on the basis of *actual* performance of any significant proportion of the population of those sub-installations.

**C1 Key Message:** any production of oxygen and nitrogen should be explicitly excluded from the system boundary in all cases where the substitutability of electricity and fuel is considered in a benchmark for free allocation.

EIGA proposes that the interests of environmental improvement, competitive equity and clarity of treatment for new entrants favour compensation for oxygen and nitrogen production being based on *ex ante* determination of *production* (i.e. historical activity levels), with benchmarks calculated *a priori* – i.e. a method consistent with the determination of free allocations.

To facilitate this approach, EIGA has defined challenging *a priori* benchmarks for oxygen and nitrogen. These benchmarks are based upon EIGA members' close understanding of the thermodynamic principles of air separation processes and reflect performance achievable from the application of "best available technology".

**C2 Key Message:** EIGA has designed and offers challenging performance benchmarks for oxygen and nitrogen, benchmarks which provide a basis for fair financial compensation for indirect emissions associated with production of these important products.

#### **D. CO<sub>2</sub> emission factor, i.e. Which method of calculation shall be adopted to establish the level of financial compensation**

It should be underlined that all the methods proposed by the Commission for calculating a CO<sub>2</sub> emissions factor will induce a degree of distortion of competition in European markets. However, distortions due to the *absence* of compensation would, EIGA believes, be significantly greater than any distortion resulting from any of the methods of calculation described by the Commission.

**D1 Key Message:** The most virtuous method of calculation should minimize distortions, reflect the realities of the European electricity market, and be transparent and practical.

It should be noted that until there is a genuine free market for electricity across the EU, a consumer in one market area (typically a MS) may have less access to low-carbon electricity than in certain other MSs; for such a consumer to meet an average sector emission target but not have access to the same range of electricity types at competitive prices would disadvantage them and distort the market.

#### **E. Other issues**

None.

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