

## Subsidising Climate Change: How industry uses the EU ETS to manipulate State Aid rules for their own profit

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### Introduction

The failure of the EU Emissions Trading Scheme (EU ETS) to reduce emissions in Phases I and II is well-documented, as is its history of providing windfall profits to fossil fuel intensive sectors.<sup>1</sup> Less well known is that these industrial sectors continue to profit from the EU ETS well into Phase III. In fact, profits for industrial polluters are set to deepen at the expense of the public purse due to little known amendments to State Aid legislation (see box one). These State Aid amendments permit Member States to subsidise industry under certain circumstances (see box four for specific circumstances) who claim that increasing energy prices (due to the full auctioning in the EU

ETS of permits of the energy industry from Phase III) will damage their business. But low carbon prices mean that energy prices have not risen for industry. Any use of State Aid would be misplaced.

This briefing explains how Member States are allowed to use the EU ETS to give public money to industry through a new set of State Aid guidelines. By looking at the criteria for State Aid, FERN argues that the low price of carbon disqualifies any application of new State Aid rules and that those rules go against the spirit of existing environmental criteria. In addition, the rules that determine whether sectors qualify for State Aid undermine the main function of the EU ETS: to decarbonise EU energy sources.

## Box one: What were State Aid rules originally intended for?

Membership of the EU formally prohibits Member States from providing subsidies (“State Aid”) to their national industries, with the aim of preventing “distortions” of free trade and competition. The European Commission’s Directorate General (DG) for Competition is responsible for policing State Aid, and adjudicating complaints between companies and Member States. It also sets guidelines on a wide range of exemptions to the State Aid rules. These allow subsidies to correct some of the excesses of the free market.

One such excess is considered to be environmental damage, and a number of State subsidies therefore claim to aim to protect the environment. To deal with this, in 1974 the EU issued the first policy statement on the role of environmental issues in State Aid rules, attempting to lay down conditions under which aid might be granted to assist industries to adapt to new environmental standards. The 2001 Community Guidelines on State Aid for Environmental Protection define ‘environmental protection’ as “any action designed to remedy or prevent damage to our physical surrounding or natural resources, or to encourage the efficient use of these resources.” These Guidelines make it clear that State Aid must provide individual incentives for companies to achieve higher environmental protection by going beyond the relevant mandatory environmental standards applicable to enterprise and industry in the EU.<sup>2</sup>

### EU ETS: a history of subsidies for polluting industry

The EU ETS<sup>3</sup> is a cap and trade system, intended to set a limit on emissions (cap) that would translate into an equivalent amount of ‘permits to pollute’. Polluters may sell these permits if they pollute less than they said they would.<sup>4</sup> In the first two phases of the EU ETS (2005-2007 and 2008-2012), EU Member States gave away the majority of these permits to companies for free. Despite this, most companies calculated the price that the permits would have cost them had they been auctioned and added this figure to consumers’ bills resulting in windfall profits for some of the EU’s largest greenhouse gas emitters. The ten companies benefiting most from free permits gained an estimated €3.2 billion in the period 2008 - 2012.<sup>5</sup> Energy utilities alone are estimated to have gained €23 to €71 billion during phase two.<sup>6</sup> The significant excess of permits on the market from Phases I and II has led many Member States to admit in hindsight that there was no real justification for the continued free allocation.<sup>7</sup>

In 2009, in the context of the financial crisis and weak EU economic performance, the EU climate and energy package (the package) was approved, including amendments to the EU ETS.<sup>8</sup> As part of the package, all industrial sectors were reviewed for their susceptibility to carbon leakage (see box 3). The European Commission (EC) identified 164 industrial sectors which they claimed were threatened by carbon leakage and should be eligible for the continued free allocation of permits.<sup>9</sup>

The ‘carbon leakage amendments’ ignored the logic that when the economy slows, so do emissions, leading to an excess of permits in the market and a natural drop in the price of carbon, making carbon leakage less likely. The EC’s own impact assessment admits that: “the carbon leakage literature does not find empirical proof of carbon leakage.”<sup>11</sup> The low price of carbon indicates that the auctioning of permits would have had no significant negative impacts on industries and economies. At the launch of CE Delft’s report on carbon leakage, participants unanimously agreed how difficult it was to measure carbon leakage. The economic crisis has had an immeasurably higher impact on ‘job leakage’ which has nothing to do with the EU ETS, and most companies pass on any cost increases to customers, so any increase in prices are rarely absorbed by industry. The CE Delft report released in April 2013 recommends a new impact assessment of carbon leakage and insists this should lead to auctioning of most allowances.<sup>12</sup>

### Perversion of State Aid rules see continuation of EU ETS subsidies for industry

In January 2013, the beginning of the third phase of the EU ETS, many energy-intensive sectors continued to get permits free of charge (as explained above). However permits for the power sector became fully auctionable. The record low price of carbon means the auctioning of energy permits has had little impact on the price of energy for industry, which means that there is still no incentive for businesses to change their energy sources or become more energy efficient. In addition, it



## Box two: What is carbon leakage?

'Carbon leakage' refers to the phenomenon whereby there is an increase in carbon dioxide (CO<sub>2</sub>) emissions in country A as a result of an emissions reduction policy in country B. It implicitly refers to the 'leakage' of economic activity and the departure of companies to another country as a result of stringent and therefore costly environmental legislation. The EC's guidelines on State Aid define carbon leakage as: "the prospect of an increase in global greenhouse gas emissions when companies shift production outside the EU because they cannot pass on the cost increases induced by the EU ETS to their customers without significant loss of market share."<sup>10</sup> The EU feared that full auctioning of permits in Phase III would further weaken the EU's economic recovery. These could be legitimate concerns, but the likelihood of carbon leakage was evaluated against a carbon price of €30 rather than the €2.81 seen in January 2013.

is well known that industry already receives extremely advantageous energy prices that are far lower than that paid by citizens.<sup>13</sup> Despite this, many industrial sectors once again cried 'Wolf', making a claim to high energy prices.<sup>14</sup>

The EC's response was to launch a consultation on EU competitiveness and energy in which the majority of respondents were from industry. The result of this are the 'Guidelines on certain State Aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012'<sup>15</sup> which were passed in 2012 with the objectives of "minimising the risk of carbon leakage, preserving the EU ETS objective to achieve cost-efficient decarbonisation and minimising competition distortions in the internal market" (2012/C 158/04).

Under the Guidelines, Member States can compensate industries that intensively use electricity as they were thought to be particularly affected by the auctioning of permits (see box two for specific rules). The rules allow partial and degressive compensation (up to 85 per cent from 2013 to 2015, gradually falling to 75 per cent by 2019-2020) of the increase in energy prices faced by the most efficient companies in each sector. The construction of new Carbon Capture and Storage (CCS)-ready (see box 3) power stations by 2020 may also receive support of up to 15 per cent of the investment costs.

The new State Aid measures outline four ways in which Member States can provide subsidies to energy intensive industrial sectors through the EU ETS. This briefing concentrates on the two most controversial of these four ways. The first is that Member States may provide aid to

sectors deemed to be exposed to a significant risk of carbon leakage due to EU ETS allowance costs passed on in electricity prices. In its Impact Assessment (C(2012) 3230 final), the EC stated that State Aid subsidies should not be used unless carbon prices rose above €30. The real price of permits and credits is however significantly lower than that estimated in the Impact assessment. According to the EC's own analysis, this should mean that the use of State Aid is out of the question.<sup>16</sup>

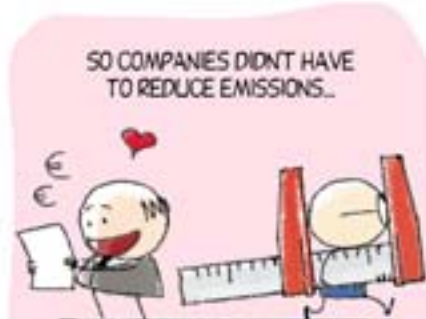
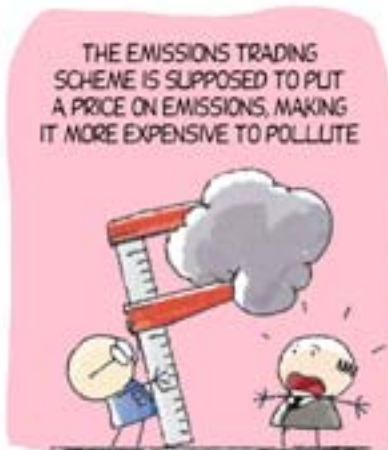
Despite this, some countries indicated that they will use these rules to provide subsidies to their industry. This has created a split between Member States that are planning on using them and those that are not, as the French delegate said: "The justification for state aid can clearly be called into question: the risk of carbon leakage is not found in the current price."<sup>17</sup> Eight governments, including France, the Netherlands and Sweden, have said the subsidy plan is too costly and would be wasteful unless the price of carbon permits climbed above €15, which remains far below the Commission's recommended figure of €30.

The second controversial state aid rule is that Member States may now provide aid to 'efficient' power plants, including, new power plants that are CCS-ready.<sup>18</sup> Furthermore, Member States are permitted to use EU ETS auctioning revenues to support "technology that reduces emissions" even if the technology has not been proven to reduce emissions.<sup>19</sup>

This is the case with NER300, that is being treated as State Aid, and so should be spent with the same accountability to the public, and the



# Briefing Note: Carbon Trading



WHEN ENERGY COMPANIES HAD TO START BUYING PERMITS, INDUSTRY ARGUED THAT RISING PRICES WOULD JEOPARDISE THEIR BUSINESS...



DESPITE CARBON PRICES BEING STUCK AT ROCK BOTTOM.



## Box three: What does CCS-ready mean?

“CCS-ready” power stations are new fossil fuel power stations which do not use, and are not required to incorporate CCS technology now, but that would be ready to do so in the future. It is widely accepted that CCS will not be ready for commercial use until 2020 or later. In other words, State Aid can subsidise investment in new fossil fuel power plants including coal power stations even if they never use CCS. The NGO Client Earth has found fault with the EC over its acceptance that Member States use public money to subsidise CCS-ready plants since this is already a requirement for coal plants under EU law and there would be few if any environmental benefits of such a subsidy. NER300 also refers to the possibility of granting financial support for the construction of “highly efficient” power plants. However there are no standards to define what “highly efficient” means. It is therefore possible to finance the building of new fossil fuel power stations with money from a system intended to help phase out fossil fuel use.

same caution as befits the spending of public revenue.<sup>20</sup> Though it aims to provide money to co-fund “innovative renewable energy technologies”, a significant proportion of accepted projects (8 out of 23) include agrofuel projects whose environmental credentials have been challenged.<sup>21</sup> As a result of the first auction of permits, 1.2 billion was raised, and of this amount, just under half went to agrofuels projects (€516 million).<sup>22</sup>

Though no CCS projects were included in the first allocation, the EC has made it clear that CCS technology will receive the lion's share of the next auction of NER 300 money.<sup>23</sup> This remains to be seen. FERN believes that the €275 million earmarked for the construction of “highly efficient” power stations has become yet another subsidy for the fossil fuel industry.<sup>24</sup> This comes as no surprise, since Shell, BP and other energy companies operating through umbrella groups such as the “Zero Emissions Platform”, helped the EC co-drafted the legislation that created the NER300.<sup>25</sup>

## Conclusion and recommendations

The revision of State Aid rules to allow Member States to provide direct subsidies to industry undermine the EU's stated intention to keep global warming to within 2 degrees. It also further undermines the stated aim of the EU ETS which is to put a sufficiently high price on carbon in order to encourage industry to become more efficient and switch to sustainable and renewable energy sources. This highlights the problem of relying on a ‘price’ to drive the necessary change to reduce GHG emissions. Using State Aid rules in the current context of rock bottom carbon prices (which means there is no correlation between the EU ETS and energy prices) should not go unchallenged. FERN makes the following recommendations:

1. Member States must not make use of new State Aid rules to protect industry from energy prices, and any attempt to do so should be legally challenged; DG Competition must ensure this
2. State Aid should be used to encourage sustainable, community-centred renewable energy projects, to improve the EU's efficiency and develop measures to reduce consumption. This should be considered as part of the modernisation of State Aid.

## Box four: How were eligible sectors chosen?

**Eligibility criteria:** The Commission used quantitative and qualitative assessments to select eligible sectors, including looking at the sectors' trade exposure outside of the EU and its Gross Value Added (GVA) compared to its CO<sub>2</sub> emissions.

**In the end, 19 sectors were considered eligible:** aluminium production; mining of chemical and fertiliser minerals; manufacture of other inorganic chemicals; lead, zinc and tin production; manufacture of leather cloths; manufacture of basic iron and steel and of ferro-alloys, including seamless steel pipes; manufacture of paper and paperboard; manufacture of fertilisers and nitrogen compounds; copper production; manufacture of other organic basic chemicals; spinning of cotton-type fibres; manufacture of man-made fibres; mining of iron ores; manufacture of plastics in primary forms sector; and mechanical pulp.



# Briefing Note: Carbon Trading

## END NOTES

1. For more information, see FERN publication 'Trading Carbon – how it works and why it is controversial' <http://www.fern.org/book/trading-carbon>
2. [http://ec.europa.eu/enterprise/policies/european-standards/harmonised-standards/index\\_en.htm](http://ec.europa.eu/enterprise/policies/european-standards/harmonised-standards/index_en.htm)
3. See DIRECTIVE 2003/87/EC. It has since been amended four times. At time of press a fifth amendment was being discussed.
4. For more information about cap and trade, see <http://www.fern.org/book/trading-carbon>.
5. For more information on windfall profits see Sandbag (2012) 'Losing the lead: Europe's flagging carbon market' [http://www.sandbag.org.uk/site\\_media/pdfs/reports/Losing\\_the\\_lead\\_modified\\_3.8.2012.pdf](http://www.sandbag.org.uk/site_media/pdfs/reports/Losing_the_lead_modified_3.8.2012.pdf).
6. WWF (2008) EU ETS Phase II – The potential and scale of windfall profits in the power sector. March 2008: and National Audit Office (2009) European Union Emissions Trading Scheme. NAO London. March 2009.
7. For more information, see <http://www.pointcarbon.com/news/1.2135045>
8. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:001:0010:0018:EN:PDF>
9. <http://corporateeurope.org/blog/carbon-leakage-threat-exaggerated>
10. [http://ec.europa.eu/clima/policies/ets/cap/leakage/index\\_en.htm](http://ec.europa.eu/clima/policies/ets/cap/leakage/index_en.htm)
11. P. 13 [http://ec.europa.eu/competition/sectors/energy/impact\\_assessment\\_main%20report\\_en.pdf](http://ec.europa.eu/competition/sectors/energy/impact_assessment_main%20report_en.pdf)
12. [http://www.ce.nl/publicatie/does\\_the\\_energy\\_intensive\\_industry\\_obtain\\_windfall\\_profits\\_through\\_the\\_eu\\_ets/1038](http://www.ce.nl/publicatie/does_the_energy_intensive_industry_obtain_windfall_profits_through_the_eu_ets/1038)
13. Compare price of electricity paid by industry (<http://www.energy.eu/#Domestic-Elec>) with that paid by domestic households (<http://www.energy.eu/#Domestic-Elec>). In most countries final electricity prices are a combination of the market prices + taxes. Final prices for energy are lower either because the electricity price is low (lower price per kwh due to special tariffs or because taxes are lower. Several countries do this. Germany for example has an EEG tax exemption for industry.
14. 'To cry wolf' is an idiomatic expression. It means 'to raise a false alarm' and is taken from Aesop's Fables, a collection of fables credited to Aesop a slave and story-teller believed to have lived in ancient Greece between 620 and 560 BCE
15. For more information see [ec.europa.eu/competition/sectors/energy/legislation\\_en.html](http://ec.europa.eu/competition/sectors/energy/legislation_en.html)
16. 2012/C 158/04
17. For more information, see <http://www.pointcarbon.com/news/1.2135045>
18. The third rule is that Member States may subsidise industry by providing transitional free allowances for the modernisation of electricity. The fourth is that Member States may subsidise small installations and hospitals by permitting their exclusion from the EU ETS.
19. See Article 10a(7) of the EU ETS Directive 2003/97/EC as amended by Directive 2009/29/EC (2008/0013(COD))
20. See p. 8 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2012:158:0004:0022:EN:PDF>. This new measure is called NER300, since it will disperse the revenue from the auctioning of 300 million permits that form part of the New Entrants' Reserve
21. [http://www.foe.co.uk/resource/briefings/agrofuels\\_fuelling\\_or\\_fool.pdf](http://www.foe.co.uk/resource/briefings/agrofuels_fuelling_or_fool.pdf)
22. [http://ec.europa.eu/clima/news/docs/c\\_2012\\_9432\\_en.pdf](http://ec.europa.eu/clima/news/docs/c_2012_9432_en.pdf)
23. [http://ec.europa.eu/clima/policies/lowcarbon/ner300/index\\_en.htm](http://ec.europa.eu/clima/policies/lowcarbon/ner300/index_en.htm)
24. [http://ec.europa.eu/clima/news/articles/news\\_2012121801\\_en.htm](http://ec.europa.eu/clima/news/articles/news_2012121801_en.htm)
25. [http://www.carbontradewatch.org/downloads/publications/ETS\\_briefing\\_april2011.pdf](http://www.carbontradewatch.org/downloads/publications/ETS_briefing_april2011.pdf)

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