



– Consultation response –

## **Feedback on the draft Climate, Energy and Environmental Aid Guidelines (CEEAG)**

Brussels, 22 July 2021 | Europex welcomes the opportunity to comment on the draft Climate, Energy and Environmental Aid Guidelines. To ensure that the policy objectives set out in the Green Deal get delivered at least cost and that the EU's internal market principles are upheld, State Aid rules need to find the right balance between supporting decarbonisation projects and minimising distortion of competition and trade in the Internal Energy Market.

For energy and emissions markets, all types of aid have distortive effects and should be minimised. Poorly designed aid instruments deployed at scale, including CfDs and CCfDs, risk undermining the functioning of these wholesale markets.

Furthermore, while we welcome the conditions under the negative criteria to minimise distortive effects, we find that additional provisions are needed to safeguard the functioning of energy and emissions markets, including a clear time limit for the aid, stronger justification of why operating aid is needed and ensuring the right selection and design of instruments.

We provide our feedback below, focusing on the type of aid, Contracts for Difference (CfDs) and Carbon Contracts for Difference (CCfDs), the compatibility assessment and the provisions related to aid for the reduction and removal of greenhouse gas emissions, including through support for renewable energy.

### **I. Determining the type of aid: operating vs investment aid**

For renewable electricity and the energy market, different types of aid could have distortive effects which should be minimised. Operating aid suppresses incentives to react to market price signals or to maximise the value of production, for example by the use of combined RES-production and storage, providing system services to TSOs, including balancing and ancillary services, and so on. This is a particular risk in some new scheme designs such as CfDs where guaranteed remuneration limits the incentive to generate alternative revenue streams or hedge in the energy forward markets.

The Guidelines should introduce a stronger justification requirement as to why operating aid should be used instead of investment aid. The current formulation (point 103) only requires Member States to demonstrate that aid allocation results in more environmentally friendly operating decisions, whereas wider market impacts also need to be taken into account.

Investment aid may lower the risk of market distortions and is easier to phase out when the desirable goals are reached. Furthermore, the findings of the EEAG support study show that *“grants had the highest effect on investment levels”* and that investment aid does not score lower than operating aid regarding the effective securitisation of investment.<sup>1</sup>

Operating aid, as further detailed below for the case of CfDs and CCfDs, can have considerable distortive effects on energy and emissions markets. This could lead to a vicious cycle wherein price-based operating aid enlarges the gap between investment costs and market value which leads to renewable energy projects requiring more subsidies to break even. This then further disincentivises renewable energy producers from maximising market revenue, leading to a larger gap between investment costs and market revenues.

## II. CfDs and CCfDs are likely to have distortive effects on energy and emissions markets

The draft CEEAG identify CfDs and CCfDs as possible forms of aid for decarbonisation. However, we believe that the potential risks of these instruments, if applied at large scale, have not been fully considered. With regard to CCfDs, the EEAG revision support study concludes that on potential competitive distortions, *“there is no literature that deals with the topic”*.<sup>2</sup>

We would therefore like to draw attention to the potential unintended distortive effects that such mechanisms may cause to the European energy and emissions markets. In particular, there are considerable risks attached to a wide roll-out of CfDs and CCfDs with potentially severe negative consequences for the efficiency and liquidity of their respective markets. In addition, alternative market-based instruments are already in place which can be more efficient in achieving the desired outcome. Consequently, we strongly advise that a thorough assessment of their potential market impact be conducted before promoting these mechanisms as valid forms of aid schemes.

**CfDs and their unintended, distortive impact on competitive energy markets:** CfDs are being promoted as helping lower capital costs and ‘derisk’ investments in new renewables. Proponents of CfDs argue that these mechanisms are able to more efficiently allocate risk among investors, consumers and the government by insulating generators from the wholesale price risk. However, if the support scheme fully socialises the risks and shields new renewable plants from the market price signal, this would severely detract from efforts to gradually integrate all generation, including renewables, into the energy market. This appears to be a particular risk with CfDs. As increasing amounts of renewable energy are deployed, sheltering significant volumes from participation in the market or in price formation undermines the meaning of the price signal. Strong price signals are particularly important as the amount of intermittent renewable energy grows, both to provide an accurate signal for dispatch decisions and for investment. Furthermore, CfD payments are typically based on this

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<sup>1</sup> EEAG revision support study: Final Report p.54 & p. VI

<sup>2</sup> EEAG revision support study: Final Report, Point 1.2.2 *“This section does not assess, however, how the subsidy design takes into account the impact on competition as there is no literature that deals with this topic.”*

reference electricity market price (e.g. the day-ahead hourly market price) – if deployed at scale, these contracts risk undermining the very reference upon which they depend.<sup>3</sup>

**Government-backed CCfDs also risk undermining the competitive emissions market:** Government-backed CCfDs<sup>4</sup> may pose a problem for the emissions market by reducing the need to hedge via the competitive market, thus leading to reduced overall liquidity and diminishing the effectiveness of the price signal as an operational and investment decisions driver. This outcome is unfavourable for both the Member States and the market as the cost of managing this risk is ultimately transferred to the public, rather than managed via the competitive energy and emissions market.<sup>5</sup>

**Additional CCfD drawbacks must be considered before implementation:** In its preparatory analysis, the Commission has identified some potential risks of adopting CCfDs: these include risks related to the government bearing the risk of ETS price variability for models where they act as the counter-party, market power risks and potential cost increases from a lack of external pressure to be efficient.<sup>6</sup>

However, the risks may go beyond what has been considered in the preparation of the revised Guidelines. Other potential CCfD drawbacks include their inability to provide substantial improvements in sectoral innovation, their reliance on public funds and asymmetry of information. First, CCfDs are usually awarded via competitive auctions and, while they support the specific projects they cover, their scope and environmental benefit is limited to those selected projects and not to the sector at large. This could also lead to a situation of double disadvantage whereby non-beneficiaries of CCfDs are financing state funding of CCfDs via the EU ETS. Second, relying on subsidies to the detriment of the end consumer when more cost-efficient market solutions are available should not be the way forward to fund the energy transition, particularly during times of tight budgets. Last, information asymmetries and the overall complexity of allocation of CCfDs can make it difficult for governments to gauge the true cost of bidding technologies and the required carbon strike price, something that competitive bidding processes can alleviate, but not eliminate. Given the rapidly changing price of EUAs and challenges in predicting the precise future level, it is exceedingly complex and nearly impossible to anticipate and reserve the exact amount of public budget needed, hence, rendering the overall budgeting process less efficient.

**Non-distortive alternatives are widely available:** In energy markets, futures markets effectively provide important tools to hedge and manage price risk through the development of liquidity in contracts with increasingly long time horizons, for example to support the development of PPAs. In a similar fashion, market participants in the emissions market can already use the secondary carbon market to efficiently manage their exposure to the carbon

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<sup>3</sup> The Europex response to the consultation on the EU offshore renewable strategy (24 September 2020) provides more detail on the potential negative market impacts of CfDs ([Link](#)).

<sup>4</sup> i.e. when the government acts as the contracting counter-party for the CCfD, bearing the long-term risk of variation from changes in the ETS market prices.

<sup>5</sup> For further detail, please refer to the Europex position paper on CCfDs and their potentially distortive effects on emissions markets calling for a comprehensive impact assessment. ([Link](#)).

<sup>6</sup> EEAG revision support study: Final Report, 2021, p.8.

price signal, in parallel with other commodities. Furthermore, there are numerous investment grants and funds available to promote low carbon technologies and mobilise funding.<sup>7</sup>

**The policy context and price trajectory of the carbon market may render CCfDs unnecessary:** Carbon prices have risen above 50 EUR/tonne in Q2 2021 and, according to some estimates, may double again by 2030. Moreover, the Phase IV reforms reducing the volume of allowances in circulation and the upcoming “Fit for 55” EU ETS and MSR revision are designed to strengthen the carbon price even further. Against this background, concerns that the EU ETS carbon price is too low to allow low carbon product technologies to be competitive may be quickly outdated.

In sum, Europex advises caution and calls for further consideration of the potential distortive impact that both CfDs and CCfDs may have on the energy and emissions markets respectively, and recommends against their wide adoption until then. Should they nevertheless be permitted by the revised Guidelines, at the very least the above concerns should be assessed and further guidance should be provided regarding:

- The scope of the CCfD schemes, which should have a pre-determined maximum volume including a trial phase with limited sectoral participation.
- A clear phase-out timeline for the duration of both CfDs and CCfDs aid schemes.
- The reference price for CfDs and CCfDs should be carefully considered and determined in the most market-neutral manner; framework guidance on the design of CfDs and CCfDs should be developed at European level. This would avoid diverging national implementation leading to an uneven playing field for the industry.
- The compatibility with the expected reforms of the EU ETS, such as an adjustment of free allocations or the introduction of a Carbon Border Adjustment Mechanism (CBAM).
- Under the premise that the Commission will ensure the application of the criteria listed under point 48 (a)-(e) of the draft Guidelines, we support the mechanism of a competitive bidding process. Efficient and harmonised competitive bidding processes are key to ensure the proportionality of the aid.

### III. Assessment of compatibility with the Internal Market

Concerning the compatibility assessment described in Chapter 3, it is vital to have in place the right framework to assess potential distortive impacts on trading conditions in the Internal Market. We generally support the framework proposed in the Guidelines that introduces a positive condition that the aid must facilitate the development of an economic activity and a negative condition that the aid measure must not unduly affect trading conditions, to facilitate weighing of these interests. However, **further safeguards are needed to ensure that**

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<sup>7</sup> Recovery and Resilience Facility ([Link](#)); NextGenerationEU ([Link](#)); Innovation Fund ([Link](#)); InnovFin Energy Demo Projects ([Link](#)); Connecting Europe Facility grants ([Link](#)); Horizon 2020 ([Link](#)), InvestEU Programme ([Link](#)); Modernisation Fund ([Link](#)); Just Transition Fund ([Link](#)); and Enhanced European Innovation Council (EIC) pilot ([Link](#)).

**the aid does not fundamentally distort energy and emissions markets** and put these market models at risk.

With regards to weighing the positive effects of the aid against the negative effects on competition and trade, we highlight the value of ex-post evaluation, whereby the Commission can limit the duration of the schemes, with the possibility to re-notify their extension. **Ex-post evaluation and the introduction of time-limitations should be done systematically for all aid measures**, in particular for more recent or relatively untested instrument designs, such as CCfDs.

**Having a clear phase out schedule for the aid is vital, as it provides an important commitment to competitive and efficient trading conditions.** The objective to phase-out subsidies according to commonly agreed criteria is necessary in order to avoid undermining the energy and emission target market models.

Concerning the assessment of the **necessity of the aid**, we support the approach in point 36 of the Guidelines which presumes that no market failure is present when *“projects or activities which, with respect to their technological content, level of risk and size, are similar to those already delivered within the Union at market conditions”*. We recommend the systematic application of this principle, including to the category ‘Aid for the reduction and removal of greenhouse gas emissions including through support for renewable energy’, and the requirement for further evidence of and justification for the need for State Aid in these cases. Given the existing market competitiveness of renewables, we encourage efforts to focus on the full market integration of renewables, rather than the implementation of aid such as CfDs aimed at supporting such projects.

Due to residual market imperfections mainly driven by an inadequate policy framework or the lack of policy coherence, we disagree with the wording “residual market failure”. We advise to use the term “market imperfection” instead of “residual market failures” to reflect the potential of improving markets by reforming the political and regulatory framework.

#### **IV. Aid for the reduction and removal of greenhouse gas emissions including through support for renewable energy**

**There is a need for further market-specific safeguards:** While we acknowledge the Commission’s intention to enlarge of the scope of the Guidelines to new areas and technologies and make the compatibility rules more flexible, there is also a need for clear safeguards to prevent distortions to markets with specific characteristics, including the energy and emissions markets.

Concerning electricity, the Electricity Regulation (EU) 2019/943 and the Renewable Energy Directive (EU) 2018/2001 have confirmed the market-based approach and the obligation for support schemes to avoid unnecessary distortions to the electricity market. The Guidelines should include the principle of market integration of renewable energy and a legal requirement to avoid negatively impacting the functioning of the electricity markets (these markets are defined in Art. 2(9) of Directive (EU) 2019/944). Importantly, this must

encompass impacts on all market timeframes, including forward, spot and balancing, markets.

Additionally, a clear and reliable phase out timeline for any support is needed. In line with the objective to reduce subsidies to a minimum in view of their complete phase out, the phase out of support should be linked to specific criteria e.g. thresholds for the share of renewables or cost competitiveness criteria such as the Levelised Cost of Energy (LCOE).

**Application of the appropriateness criteria:** we do not consider there to be sufficient justification to exclude the category *“Aid for the reduction and removal of greenhouse gas emissions including through support for renewable energy”* (Section 4.1) from the general appropriateness criteria (Section 3.2.1.2). Particularly for energy and emissions markets, removing the assessment of appropriateness among alternative policy instruments creates a high risk of undermining the efficiency of the market-based mechanism when addressing residual market failures. For example, there may be overlap and interaction between the ETS price signal applying to power generation and certain types of renewable support schemes. Equally, the choice of the aid instrument is critical to minimise distortion to trade and competition in energy and emissions markets, and there should not be an automatic assumption that alternative policy instruments are insufficient. We therefore recommend applying section 3.2.1.2 also to this category of aid.

**Application of criteria related to the necessity of the aid:** Point 34 of the draft Guidelines (The existence of market failures not being sufficient to prove the necessity of State Aid and requirement for the Member State to identify any existing policies and measures that already target the identified regulatory or market failures) should also be applied to the category *“Aid for the reduction and removal of greenhouse gas emissions including through support for renewable energy”* (Section 4.1). The interconnected nature of the ‘Fit for 55’ policies, including the upcoming EU ETS Review which will further the internalisation of CO<sub>2</sub> emissions, justify a careful examination to ensure that State Aid measures are only targeted at genuinely residual market failures.

Point 36 states that in principle, the Commission will presume that no market failure is present where “projects or activities which, with respect to their technological content, level of risk and size, are similar to those already delivered within the Union at market conditions.” We believe this should equally apply to the sectors eligible for aid regulated in chapter 4.1. Excluding this category of aid from this assessment would remove the possibility of this sensible starting point and risk a situation where developments in cost-competitiveness in renewable energy are not fully taken into account.

**Preservation of efficient operating incentives and price signals:** It is positive that the draft Guidelines recognise the importance of beneficiaries remaining exposed to price variation and market risk. We support requirements that beneficiaries should not be incentivised to offer their output below their marginal costs and must not receive aid for production during periods of negative prices.

## About

Europex is a not-for-profit association of European energy exchanges with 29 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

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