

# UK GOVERNMENT RESPONSE TO THE EUROPEAN COMMISSION QUESTIONNAIRE ON THE REVIEW OF THE CURRENT *COMMUNITY GUIDELINES ON STATE AID FOR ENVIRONMENTAL PROTECTION (2001/C 37/03)*

## A. General Questions

The UK welcomes the Commission's commitment to revising their guidelines on State aid for environmental protection and its early consideration of what changes may be necessary to the existing guidelines. The UK is a strong supporter of the need to amend the current guidelines so that they better reflect the need for Member States to combat market failures and encourage better environmental performance. We have already forwarded the Commission a paper setting out the UK's thoughts on the difficulties presented by the current guidelines and how they may be amended to address these problems. Copies of the UK's Road Map response and the paper on reform of the environmental guidelines can be accessed on the internet at the following web-link: <http://www.dti.gov.uk/bbf/state-aid/reviews/index.html> A copy of the environmental aid paper is also annexed to this response for convenience.

Prior to addressing in detail the questions posed in the Commission's questionnaire we would like to make a few general, preliminary remarks:

- (i) The UK supports tight control of distortive state aid: the UK's suggestions on revisions of the environmental guidelines are entirely consistent with the Commission's stated policy of focusing resources on such distortive aid and of taking a more flexible approach to state aid that is generally considered not to have a significant impact on competition. We also support the Commission's attempt to inject more economic and market impact analysis into the assessment of which aids should be approvable. It is important that such approaches should be carried forward into consideration of environmental aid.
- (ii) The UK considers that there is a fundamental economic difference between a "pure" subsidy to a company on the one hand and a payment to achieve an environmental objective, **which would not otherwise be achieved** on the other. The Environmental Guidelines should recognise that:
  - where companies are not *obliged* (e.g. by law such as the EU Environmental Directives) to improve environmental performance and such improvement involves a net cost to the company, state payment of the minimum necessary to secure the improvement will not provide a material advantage to the company receiving the payment and will therefore not significantly distort competition. It will merely offset the non-economic cost to the company of the environmental gain. Such payments are not aid at all if they provide no advantage whatsoever to the recipient. In cases where marginal advantage to the recipient cannot be entirely excluded, the aid should always be approvable, regardless of the location of the investment, as long as the environmental gain is legitimate and the procedures for ensuring that the minimum necessary is paid are sufficiently robust;

- where companies are subject to environmental regulations (or taxes) which impose costs upon them, this will distort competition unless such regulations/taxes are imposed equally on all their competitors. In practice this is not always the case, so to avoid Member States and the EU as a whole being deterred from introducing such regulations/taxes, the Commission must allow some flexibility for Member States to respond to the additional costs of achieving environmental gains with compensation, especially if that Member State has in practice imposed higher environmental standards than other EU Member States. Such compensation may be pro-competitive, rather than distortive as well as enabling a greater degree of pro-activity by Member States for achieving environmental gain.
- (iii) at all times, no more aid should be permitted than is strictly necessary to achieve the environmental objective (within the limits of administrative efficiency) and this should be in proportion to the objectives sought;
  - (iv) the purpose of environmental aid must be solely to achieve European and Member State environmental goals – not to achieve industrial or economic growth goals. This means that environmental aid should either be offered to all companies subject to a particular environmental challenge or in a position to achieve the particular environmental gain or be offered through competitive process to those undertakings which can achieve the environmental gain at best value; and
  - (v) the UK recognises that this area is complex and that there may be more than one way of achieving these environmental objectives. However it is important that the revised Environmental Guidelines should facilitate the achievement of such environmental gains where State aid is the appropriate instrument.

## 1. Scope and Application of the Guidelines

*So far, the scope of the Guidelines has been kept limited to environmental aid. But several areas are connected to or similar to environmental aid with strong parallels in the argumentation for aid grants. One question is therefore whether the current scope of the Guidelines should be kept, or if other areas could be included?*

The UK considers that the broad objectives of the guidelines should continue to apply to aid in support of environmental protection and performance. However, having said that there is some room for broadening the scope of the Guidelines within this definition.

The Environmental Guidelines should be able to allow the approval of aids in support of more global and strategic measures which are vital in the interests of environmental protection and sustainable development. This should still be concerned with support for those areas already covered by the Guidelines, for instance:

- “environmental protection”;
- action to “remedy or prevent damage to our physical surroundings or natural resources”;
- “sustainable development”; and
- “environmental objectives”; and recognise
- the need to “encourage the efficient use of these natural resources”.

However, while these objectives are set out clearly at the beginning of the current Environmental Guidelines, later passages and the Commission's interpretation of them have, in the past, meant that a number of important environmental initiatives could not be supported. In particular the new Guidelines should explicitly include principles-based provisions to allow aid in support of, *inter alia*:

**(a) Aid to address “Environmental Harms”**

“Emissions and pollution” are only one of many sorts of environmental harm: it is vital that Member States should be able to take steps to achieve the above environmental objectives and to tackle other forms of environmental harm by all available means (including state aid where the other pre-conditions for granting aid are met);

**(b) Effective targeting of aid to maximize environmental benefits in other parts of the production and consumption chain**

The current application of the Environmental Guidelines focuses on support to help a company “improve its own environmental record” or “to reduce its own pollution”. This is not always the most efficient way of dealing with an environmental problem – either from a state aid or an environmental policy perspective. It is often more effective to support investments which act as a catalyst and deliver environmental benefits well beyond the point at which the intervention is made in the production cycle. This would allow Member States to determine the point in the supply/production/services chain where intervention will most effectively be able to incentivise environmental gains along the entire chain. This enables the maximum environmental benefit to be derived from the minimum state intervention and ensuring that no more aid is given than is “strictly necessary” to achieve the environmental objectives in question.

**(c) Environmental Benefits**

The Commission's current interpretation of the Environmental Guidelines ignores many direct and indirect environmental benefits, not just to the recipient of the aid, but to the wider Community (and, indeed, the Member State and the EU as a whole) in terms of a better use of natural resources, reduced emissions of greenhouse gases and other pollutants, increased recycling of waste, reduction and remediation of pollution, reduced landfill etc.

**(d) Aid for environmental technology/process demonstration and pump priming to encourage development of markets for beneficial environmental technologies/processes**

In many cases the market failure which prevents take-up of new technologies is not purely economic. Asymmetry or indeed non-availability of information is a recognised block on effective operation of markets. Where such problems exist they are likely to deter early adoption of processes or technologies which would bring a significant environmental benefit. In developing revised environmental guidelines the Commission should consider how aid may be approved to

demonstrate new environmental technologies where these factors (rather than purely economic ones) are preventing take-up by the market.

The UK would envisage that where any such near-market demonstration was approved this should be on the basis that it was carried out through a competitive opportunity allowing interested parties to bid for support, that data from the demonstration project should be gathered and be widely disseminated throughout interested parties in the sector, the public sector and academia, that provision should be made within the project for inspection of the project by academia/the sector/the public sector and that benefits accruing to the operator of a demonstration (arising from their participation in the demonstration) should be clawed-back at the termination of the project.

Provisions relating to the granting of such aid may be closely related to the existing provisions for “demonstration projects” allowed under the Framework for State Aid for R&D” which exclude any demonstration project which is capable of being operated at a commercial scale. This prevents support for new environmental technologies where the aid will help in commercialization. This may produce results either directly through the development of a commercial market for the technology or indirectly through the project helping to overcome information barriers. The environmental benefits from the aid will therefore accrue from future applications of the technology as well as the applications being supported by the aid.

In 2004 the Commission approved a UK scheme (N385/02) to allow the remediation of land where prior industrial activity has caused harms (other than chemical pollution) which render the land unsuitable for profitable use. Such harms could include derelict buildings and other industrial structures or undermining and subsidence of land through mineral extraction and mining activities. The provisions for remediating such land allowed under the approval mirror closely the guidelines’ provisions for the remediation of chemical and similar pollution (although the scheme was approved on the basis of the treaty rather than under the environmental guidelines). The UK considers that provisions relating to the remediation of such physical harms should be included in the revised guidelines.

*- Safety and the environment: Should the .safety of civilians and their environment”, “safety of employees”, “health of consumers” and “health of employees” be included in the scope? If so, are specific rules needed - other than the current rules for environmental aid?*

The UK considers that the assurance of public health and employees health is an important area of public policy. However, it considers that many of the provisions necessary to achieve improvements in such areas should already be available under the existing laws relating to the environment, employment, consumer protection and health and safety. Such legislation already sets a minimum necessary level of protection and it would **not** be appropriate for Member States to fund their enterprises to meet such legal obligations.

However, the UK can see that there may be a case for allowing certain improvements beyond the standards set in legislation. This parallels principles already set out in the environmental

guidelines for the subsidy of improvements beyond existing (EU) standards. Where provisions for increasing the safety of employees and consumers are concerned the UK is not sure that the environmental guidelines would be the most appropriate vehicle for such, albeit valuable, provisions beyond the extent to which they already address these issues.

Where they are outwith the environment the Commission should consider where such provisions should be placed but this will be a discussion for another forum – not under consideration of the environmental guidelines. In view of this the UK sees no rationale for their inclusion within the guidelines.

*The current rules for environmental investment aid cover aid for investments that help to reduce the beneficiary's own pollution. The Commission sees a clear need to lay down explicit rules for environmental investment aid to companies in order to deal with pollution caused by other companies. See more specific questions under B7*

The UK considers it very important that the guidelines should allow scope to consider the benefits of environmental aid beyond the direct effects on the aid recipient when determining compatibility of aid. This is one of the biggest weaknesses in the current guidelines. This topic is explored in more detail in our paper on Environmental aid and section 7 below.

## **2. Refined economic approach**

*The State Aid Action Plan has outlined the general balancing test that is used in state aid policy:*

1. *a well-defined objective of common interest has to be identified (ex: cohesion, growth, employment, environment)*
2. *the aid instrument has to well target the identified objective of common interest :*
  - *State aid is the appropriate policy instrument .*
  - *The aid measure has an incentive effect .*
  - *The aid measure is proportional to the problem tackled*
3. *the distortions of competition and effect on trade should be limited so that the aid measure is not on balance contrary to the common interest.*

*The current guidelines are already largely consistent with this test, but the revision of the Guidelines on State Aid for Environmental Protection should be used to clearly implement the balancing test and to better justify the proposed rules on the basis of a refined economic approach.*

As noted in our paper on Environmental State aid the purpose for which state aid is granted under the environmental guidelines is not for economic development purposes but rather for the achievement of environmental gains which would not be spontaneously undertaken by the market or to incentivise the earlier implementation of such gains. The UK considers that the Commission should take greater account of such environmental gains when considering the compatibility of aids under the guidelines.

As noted above and in our paper the UK questions whether the payment of the minimum necessary to a company to achieve a particular change in behaviours to assist environmental protection and performance confers any competitive advantage on the recipient. In such a case the existence of aid in such circumstances is questionable. If the Commission considers that there may be some level of advantage accruing to the recipient the UK argues that such aid should be automatically approvable so long as the aid giver can demonstrate, e.g. through

the use of some form of transparent competitive process, that the award is the minimum necessary to achieve the change in behaviour.

The UK can see no economic basis for distinguishing between aid to reduce a company's own pollution and aid which enables the company to deliver any other type of environmental gain. What counts is whether the aid responds to a market failure (in which case it will not distort competition) or offers a genuine subsidy (in which case there will be distortion of competition and it must be tightly regulated). The Commission should give more weight to the wider environmental benefits (beyond the recipient of the aid themselves) arising from the granting of environmental aid when considering the approvability of environmental aid. Such environmental benefits should be taken as a counterbalancing effect of any perceived distortion of competition arising from the aid.

*On the basis of past experience, the Commission is interested in getting views about identified market failures, which have a negative impact on Environmental Protection, and which could be remedied through State aid. It is also interested in getting views about other justifications that have been used to grant State aid for Environmental Protection.*

The current guidelines already contain a number of detailed provisions related to specific environmental activities (renewable energy, waste management, CHP, energy saving, pollution remediation etc). The UK is concerned that the development of activities and technologies within the environmental sector have already made this list of activities out of date. This has caused the Commission significant problems in approving aid under the current guidelines where there is not a clear match between the activities to be aided and those covered in the text. This has led to unnecessary delays in the approval of otherwise reasonable schemes which present small levels of distortion to competition – often necessitating the opening of an in-depth scrutiny procedure under Article 88(2) of the Treaty. We would be concerned that the inclusion of a further, non-exhaustive list of activities will present the same problems and rapidly become out of date. The definition of environmental aids within the guidelines should be broader, principles-based and more facilitative, allowing the Commission to then consider on its merits whether a particular type of aid and the method under which it will be delivered includes a level of distortion of competition which is compatible with the internal market.

Market failures in relation to environmental protection are many and varied because private activity will always have an impact on collective environmental assets and it is impossible and probably undesirable to regulate private behaviour to the extent necessary to fully cater for the collective good. Governments, therefore, use a mixture of regulation, state intervention and incentives to drive environmental gains – from lower taxes for energy efficient vehicles and appliances or rules and incentives to promote use of brownfield land for housing to market structures favouring renewable energy and grants for doorstep collection of recyclable materials. The Commission must allow Member States significant discretion over which instruments to use and how best to achieve the environmental gain in the conditions which prevail in each country, as long as Member States do not, thereby, create serious distortions of competition. In view of this, rather than seeking to enumerate all environmental market failures and lay down rules stipulating how each one may be remedied, the Commission should instead lay down principles according to which it will approve any payment to remedy

an environmental market failure. It would then be for Member States to demonstrate the existence of the market failure and to show that the aid was the minimum necessary etc.

*More generally, the Commission is interested in gathering opinions about the opportunity to adjust the current approach in the guidelines, e.g. to elaborate further on the distortions of competition and effect on trade of specific measures and possibly differentiating the rules according to economic parameters (ex: market structure, relevant market, market shares of the aid recipient etc.).*

The UK's proposals on the treatment of environmental aid is set out in more detail in the annexed paper. However, we question whether differentiating the rules according to economic parameters such as market structure, market share etc will be relevant in the case of aids where aid is being granted for performance which goes beyond what should be undertaken by the recipients in the course of their ongoing general business. If an environmental payment only compensates for a market failure it confers no economic advantage and the market share and size of the recipient is not important. Market share and structure of the relative market may be relevant where aid is sought specifically to stimulate a market or the early uptake of a particular environmental process/technology. For example, to the extent that it is difficult to quantify the minimum necessary, such that some advantage to the recipient may occur. However, in such cases other methods, such as competitive tendering, should be available to eliminate any potential distortions.

### **3. Possible Block-exemption Regulation**

*As laid down in the State aid action plan, a block-exemption regulation could be introduced for environmental aid. Which category/ies of environmental aid would you consider suitable for inclusion in such a block exemption?*

The UK strongly supports the use of a block exemption for the approval of certain types of environmental aid but accepts that many environmental aids require assessment of market failure and verification that the minimum necessary has been paid. These types of aids do not lend themselves to a Block Exemption treatment other than where the risk of distortion of competition is low anyway. A Block Exemption will require the setting of simple and straightforward criteria for the types of aid which should be approvable under the block exemption. There are a number of criteria and conditions which may be suitable for usage under a block exemption to define where an aid may have a limited distortionary effect. Certainly it may be possible to block exempt certain aids to SMEs for environmental purposes. This could include aid in a range of areas already included in the guidelines, including but not limited to, waste management and disposal, recycling, remediation of contaminated land (including remediation of non-chemical pollution/damage), renewable energy and energy savings, aid for improving on community standards etc.

However, since the block exemption should be capable of being applied in a simple manner the UK considers that the Commission should consider how to simplify the calculation of eligible costs and aid levels for aid granted under the block exemption. This could be done in a variety of ways. If the Commission decides to retain the extra cost approach to calculation of eligible costs they should consider allowing the full extra costs to be funded whether or not this is adopted as a general principle across the guidelines. In addition, under the block exemption there should be no need to net off revenue arising from the investment over 5

years as under the current guidelines (as is the case currently under the guidelines). This would, at least, have the virtue of simplifying the calculation of eligible costs and assist in making the operation of an environmental Block Exemption regulation simpler to operate in practice. If the levels of aid available under the Block Exemption are relatively modest this should not cause undue distortion of competition.

If the Commission wishes to retain a “percentage of eligible costs” approach then the eligible costs should be calculated on the basis of the full project costs.

The UK considers that it would be appropriate to include protections under the environmental block exemption similar to those in the SME block exemption to avoid the granting of very large aids without formal Commission scrutiny. This could take a similar form as under the current or any future consolidated block exemption regulation. For example all individual aid awards over a certain size (e.g. where total eligible costs are over €25m or total gross aid amount is over €5m). Where possible these criteria should harmonise with those in the general block exemption regulation.

#### **4. The Polluter-Pays Principle**

*Should the polluter-pays principle be strengthened? This could mean a somewhat stricter application of the Guidelines, resulting in less aid being approved for companies polluting. Which consequences for instance concerning tax derogations?)*

The UK is a strong supporter of the “polluter pays” principle. This should remain a bedrock on which the environmental guidelines are founded. This is a necessary tool to ensure that any environmental investments retain additionality.

However, the Environmental Guidelines need to recognise that there are limits to the concept of cost internalisation in the context of environmental issues, especially where a more environmentally-beneficial approach is not mandatory. For example, it is not clear that a producer should be required “to internalise” the environmental costs of his current choice of, for example, virgin raw materials, rather than recycled raw materials.<sup>1</sup> There are also situations where, even though costs may be internalised, it may still be appropriate to permit state aid under the guidelines – for example, to stimulate new technology.

#### **5. Current aid percentages kept, increased or lowered?**

*A critical element in the current guidelines is the ability to create an incentive to achieve levels of protection which are higher than those required by Community standards. On the basis of experience, and for each of the Chapters in the Guidelines, should the current percentages for accepted aid be kept, increased or lowered?*

The annexed UK paper sets out in detail our concerns about the Commission’s current approach to calculation of aid intensities under the guidelines and sets out proposals for an alternative methodology. However, we would make the following points.

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<sup>1</sup> The producer should not be seen as the “polluter” in these circumstances. Furthermore, there is no need to view the producer as a polluter once it is accepted that the Environmental Guidelines can permit support for measures designed to achieve global objectives, rather than simply reducing on-site pollution (cf point B.2 above).

The UK considers that clarification of point 37 of the current Environmental Guidelines would be helpful. In particular, this point tends to lead to an approach which looks to compare the costs of an environmentally friendly investment, with the cost of an environmentally “unfriendly” project. While, in some cases, this would be appropriate, in many cases it will not (because there is no “unfriendly” comparator). As the Commission has recognised in a number of cases,<sup>2</sup> this approach is not required by paragraph 37 and refocusing any such paragraph in the revised guidelines would therefore be welcome. The UK would make three particular comments/suggestions on this:

- the “minimalist” approach to such a clarification might simply entail deleting the word “extra” in the first paragraph of paragraph 37;
- the Guidelines should allow support for investments which compensate for environmental “externalities”. For example, the rules on operating aid for renewable energy in section E.3.3 (Option 3, para 63) of the Environmental Guidelines allow aid to be calculated on the basis of the avoided external costs (in effect, the real environmental benefits of the investment or the cost of the market failure). There is no reason, in principle, why this approach should only be confined to renewable energy – it could equally well apply to other environmental technologies, including resource efficiency investments such as those designed to establish recycling capacity; and
- the costs would be eligible up to the lesser of the cost of the extra cost of the environmentally “friendly” technology or the cost of the avoided external costs.

The Commission should reconsider the effective allowable percentages at which interventions can be made under the guidelines in the light of changes in markets and technologies. The UK would prefer the maximum permitted aid intensity for environmental aid to be “the minimum necessary” to incentivise environmental performance/improvements which would not otherwise occur, as explained elsewhere. However, even if the Commission does not accept this approach, the current system still needs reform.

While the maximum aid intensities provided under the guidelines of around 30-40% may seem appropriate and in line with the intensities allowed in other horizontal frameworks, this gives a misleading view of the aid intensities which are actually allowable. The restriction to aiding purely marginal environmental costs of a project actually leads to aid intensities which are significantly lower than the nominal figures. In many cases the effective maximum level of aid allowed under the Environmental Guidelines may simply be insufficient to allow a project to go ahead. Valuable environmental gains will therefore be lost; in particular, where the aim of a measure is to address a market or financing failure in an environmental market (rather than “greening” an existing market’s activities) the model described above. The amount of aid needed depends on the scale of the market failure and because these are multiple and varied across the entire environmental field, fixed percentages cannot hope to be flexible enough for purpose. This has been demonstrated in the difficulty which the Commission has had in approving entirely reasonable and proportionate Member State schemes within the scope of the guidelines.

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<sup>2</sup> E.g. in the *WRAP Scheme* decision or in the *Photovoltaic* decision.

There should be scope for wider environmental effects to be taken into account in the consideration of a proposed aid: in particular, schemes which support activities which will have a wider effect across a market to produce an environmental benefit (or a number of environmental benefits).<sup>3</sup> If aid is particularly beneficial, some small distortions of competition may be an acceptable price to pay to achieve the additional environmental benefits.

However, should the Commission retain its current regional aid-style maximum aid intensities, at the very least, it should be possible for the Commission to re-consider the way in which the eligible costs to which the aid intensities apply are calculated. For example, as noted above, no account is taken in the current guidelines of environmental effects beyond the direct recipient of the aid. This should be included within any future guidelines. Furthermore, as noted above, the model on which the calculation of marginal environmental costs is based is no longer sufficient to cover the range of projects for which approval is sought under the guidelines. Many current aid schemes, particularly those which are designed to remedy market failure to achieve the desirable environmental outcome and offer the minimum necessary to achieve that objective can be argued to contain little or no “non-environmental” element and, therefore, all their eligible costs should be able to be considered for funding. The revised guidelines should deal with such a possibility.

If the Commission considers that this is not possible then there may be other ways to ensure that there is sufficient scope to provide levels of aid sufficient to incentivise improved environmental performance. For example, an approach along the following lines could be adopted. It may be possible to increase the aid intensity which may be applied to the marginal environmental costs of a project to a higher level – say 50-60% - while retaining a provision that no aid may be granted above 30% of the total eligible costs of the project. This would provide for higher levels of aid where necessary while retaining discipline on overall levels of aid. It should be emphasised again, here, that the UK believes that even under such arrangements, no more aid should ever be permitted that that strictly necessary to achieve the objective in question and additionality should be demonstrated in all cases.

## **6. Higher aid levels for SMEs and assisted regions . justified?**

*In the current Guidelines, SMEs are allowed higher aid levels in a number of cases 10 % higher than aid for other companies (points 35). Although generally SMEs may be limited by market imperfections, have restricted access to information and perhaps limited access to risk capital, it can be discussed whether a 10% higher aid level for SMEs has a positive effect on the environment.*

*Similar questions could be raised for the additional aid for assisted regions which allow a similar bonus (points 33-34), which can be cumulated with the SME-bonus. Does this have a positive effect, and should this still be allowed?*

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<sup>3</sup> For example, an investment in a recycling facility will have a direct benefit that recycling of a particular product will increase. However, the project may also be configured to achieve other important environmental effects as second or third-order effects – for example, an increase in use of waste feedstock will remove material from landfill, increase efficient usage of existing natural resources and the arrangements for collection of the waste feedstock may create sufficient critical mass to incentivise the collection and recycling of other materials etc

The calculation of eligible costs suggested by the UK would allow the minimum necessary aid to be granted to bridge the market failure/gap preventing environmental improvements to be undertaken by companies. Under such a regime where the extra costs of providing an environmental benefit may be covered there is no rationale for additional top-ups, whether for assisted areas, SMEs or other purposes. Certainly there would be no environmental incentive effect of such top-ups and they would constitute pure subsidy. Any extra support for firms in assisted areas or for SMEs should, therefore, have to be treated as regional/SME aid and approved separately on that basis.

The UK considers that environmental market failures are broadly the same irrespective of location. Consequently the UK does not support higher levels of environmental aid in assisted areas. Similarly, it is not clear that there is a need for a particular bonus for environmental aid to SMEs.

Were the Commission to retain its current approach to the calculation of eligible costs the UK may consider it necessary to support the retention of SME and regional top-ups. This would be an unsatisfactory position because the support would not necessarily be being given on the basis that the UK considers that such top-ups are valid or necessary. Rather it would be on the basis that the additional aid intensities afforded by such top-ups would assist, at least in some limited circumstances, in ameliorating the inherent deficiencies in the guidelines' treatment of eligible costs.

## **7. Possible aid for Environmental Innovation**

*The State aid action plan explained stated that the Commission will attempt to encourage ecoinnovation and improvements in productivity through eco-efficiency in line with the Environmental Technologies Action Plan (ETAP).*

The UK is a strong supporter of the European Environmental Technologies Action Plan (ETAP). The promotion of innovation in the field of environmental technologies (using the broad definition of such technologies in the ETAP, which encompasses new processes, techniques and management tools) has the potential to make a significant contribution to the EU's performance on environmental issues and its ability to meet various national, EU and international targets on environmental protection and performance. It is important that any guidelines on environmental state aid facilitate the incentivisation of the development and uptake of such technologies and processes. It may be the case that some such support may have a degree of distortion of the market but the UK considers that, provided that any such aid contains necessary protections to minimise the distortion of competition, the Commission should consider whether the environmental gains arising from the support acts as a counter-balancing effect, justifying the aid as compatible with the treaty.

*Environmental investment aid can be granted when companies invest to reduce pollution further than would be required on the basis of community norms. Community norms may often derive from the Best Available Techniques, so environmental investment aid can be expected to encourage companies to introduce environmental innovations in their production process. The current rules do not foresee investment or operating aid for innovative products that reduce pollution because they are direct substitutes for more polluting conventional products.*

The UK believes that the approach in the last sentence of this question – “*The current rules do not foresee investment or operating aid for innovative products that reduce pollution because they are direct substitutes for more polluting conventional products*” – is unnecessarily restrictive. It does not take account of the additional perceived risks (both commercial and technological) of the development or early adoption of innovative products and processes to reduce pollution beyond existing Community standards. It should be possible, under certain circumstances, to obtain approval of aid to incentivise demonstration of innovative environmental technologies or early adoption provided that the additionality of the aid could be demonstrated and that significant environmental gains would be achieved. This has clear links with the work currently being done by the Commission in relation to their Communication on State Aid for Innovation.

What matters here is whether investment in innovative, pollution reducing products which substitute more pollution products would be undertaken anyway by the market. If such replacement is mandatory by regulation or in the company’s own economic interest then no environmental aid should be allowed. If, by contrast, the market would not support such investment, minimum necessary aid should be allowed in the environmental interest.

*Where aid goes beyond the .state of the art., this could in some cases be considered aid for new technology. Environmental aid is often related to innovation, although this depends on the kind of technology in question. Which category of eco-innovation aid would you consider necessary/compatible? Which kinds of rules are needed? (Examples of aid: Fiscal incentives? Energy Efficiency? Energy Savings? Others?)*

The UK agrees that provisions relating to aid in support of environmental innovation should be included in the revised guidelines. However, we are reluctant that this should be drafted in terms of a list of particular technologies. The nature of innovation is such that any list, however exhaustive at the time of publication, would quickly become out of date. Any such provisions should be principles-based and cover the full scope of the environmental guidelines. This would allow the Commission to consider each proposed aid on a case by case basis to determine whether the aid was compatible.

## **8. Individual Notification Thresholds**

*Should the thresholds in point 76, above which individual cases under approved schemes have to be notified individually, be revised? Is there a need to have different thresholds for different types of cases?*

The UK agrees that very large awards of aid have a particular ability to cause distortion of the market through sheer scale alone. We agree with the inclusion of a requirement that all aids over a certain size threshold should be notified to the Commission for individual scrutiny even if they would, otherwise, fit under a previously approved scheme. The threshold levels in the current guidelines (aid granted under an authorised scheme where the eligible costs exceed

€25m or where the aid exceed a GGE of €15m) seem broadly appropriate. The Commission may wish to consider whether the current thresholds (which were set in 2001) may need to be increased to take account of inflation, economic growth etc.

We do not see a case for different thresholds for different types of environmental aid. Wherever possible such threshold criteria should be standardized across the horizontal guidelines.

## **B. Specific chapters of the current Guidelines**

### **9. Investment Aid**

*Should SMEs still be allowed transitional investment aid up to 15 % of eligible costs for three years from the adoption of new Community Standards? Normally no aid is allowed for aid to reach community standards . but up to 30% aid for eligible costs can be authorised to improve on Community Standards. Is there a guarantee that the transitional investment aid up to 15 % of eligible costs for SMEs has an effect - or should the percentage be lowered / increased?*

The UK does not support aid to help companies defray the cost of compliance with new mandatory standards. Such aid does not meet a market failure and distorts competition. Such aid offers no specific environmental benefit and should be assessed under the Regional aid Guidelines and the SME Block Exemption. Given that Community Standards apply equally to all Member States we see no *prima facie* need for such transitional compensation.

On the other hand we do not support the imposition of an arbitrary maximum of 30% for investment aid to go beyond mandatory EU norms. The maximum amount allowable should be the demonstrable minimum needed to overcome the market failure which is inhibiting achievement of the higher environmental result – if necessary, 100%.

*For renewable energy and cogeneration up to 40% of eligible invest aid may be authorised, in some special cases for renewables up to 100 % - Which area of renewable energy do you consider most experimental/furthest away from market maturity to justify such higher intensities? Would you consider rates of up to 100% still justifiable? Should the levels be increased / lowered?*

The UK has set out its preferred approach to the calculation of eligible costs and aid intensities elsewhere. This approach should apply in this area also. However, should the Commission decide to retain a percentage of eligible costs based approach we would support the ability to grant higher levels of aid (potentially up to 100%) where this reflects the severity of the risks and the depth of the market failure being addressed by the aid. We would be reluctant to list particular areas or technologies where this could be applied. Rather, each case should be considered on its merits.

*Could a better / stricter definition of eligible costs be formulated, to avoid difficulties?*

See comments elsewhere and in the annexed paper.

*Should aid for rehabilitation of polluted industrial sites of 100% of eligible costs as well as 15% of the cost of the work be authorised? Is the level too high/too low?*

The UK considers that the retention of this aid in the guidelines is justified and that the aid levels are broadly appropriate. However, the UK also considers that the scope of these provisions should be widened to include aid for the remediation of land where prior industrial activity has caused harms (other than chemical pollution) which render the land unsuitable for profitable use, e.g. derelict buildings and other industrial structures or undermining and subsidence of land through mineral extraction and mining activities. This would reflect the types of aid approved by the Commission in the UK scheme, N385/02.

*The scope of relocation rules is limited, and restricted to environmental protection grounds. Should the scope be loosened or expanded to include other criteria, e.g. security in urban areas?*

The UK is content with the inclusion of these provisions. We do not see a compelling reason to broaden their scope.

*Should aid to live up to national standards higher than the Community Standards be authorised?*

The UK strongly believes that Member States should have the scope to apply for approval of aid to assist companies comply with national standards where those standards go beyond EU standards. Such aid should be treated no differently from any aid granted to improve on Community Standards. Should assistance to comply with national standards where those standards go beyond EU standards be excluded from the guidelines it is likely that it would have the effect of deterring Member States from using national standard setting powers to achieve increases in environmental performance because of fears that this would economically disadvantage their domestic companies (in comparison to other Member States with less ambitious national standards). This would tend to have a negative effect on environmental performance across the EU and run counter to Community policies on environmental protection and performance.

*On aid for spending on technology transfer: Do the three conditions reflect current market realities, or should they be changed?*

The UK is broadly content with these provisions.

*As mentioned above (point A.1), the Commission sees a clear need to lay down explicit rules for environmental investment aid to companies in order to deal with pollution caused by other companies. This may concern a wide range of situations, e.g. investment aid in waste treatment or recycling capacity, investment in transport infrastructure such as pipelines, investment in production capacity of products which are environmentally friendly substitutes for conventional products. The new rules will have to ensure, among others, that the 'polluter pays principle' is not circumvented and that the environmental benefits are real. Which rules are needed and how much aid could be allowed?*

The UK considers that it should be possible for Member States to address environmental problems and market failures in the environmental field at the point in the supply/environmental chain where aid can most effectively be used to correct the market failure or incentives changes in behaviour. This should assist in minimising the amount of aid necessary to achieve any particular environmental benefit. As such the Commission should

be able to consider the wider environmental effects and benefits arising from any environmental aid when considering compatibility with the Treaty. The UK position is set out in more detail in the annexed paper.

*The calculation of eligible cost, taking into account the net benefits over 5 years, can be quite complicated in certain cases. Is a simplified calculation needed and possible (perhaps limited only to cases up to a certain size)?*

The UK considers that this is an arbitrary and unnecessary element within the calculation of eligible costs. It should be pointed out that no other state aid framework or guidelines offering maximum fixed percentage investment aid require the netting off from eligible costs of the net benefits accruing from the receipt of aid. The UK supports, in principle, the netting off of benefits to the company against costs of environmental improvement. This is what defines the market failure. What is anomalous is to then impose a fixed maximum aid intensity. Logically Member States should be allowed to fund the entire gap between cost and benefit as the company receives no benefit, by definition, from this funding. Nevertheless, if the Commission persists with its approach to maximum aid intensities the removal of the netting-off would, at least, greatly simplify the calculation of eligible costs. The UK considers that, in this scenario, fixed maximum percentage aid should be granted against the full additional costs of achieving a particular environmental benefit – this has been discussed in more detail elsewhere.

## **10. Operating Aid - Waste Management, Energy-Saving, Renewables, CHP and Tax Reductions/Exemptions**

*Should the scope of the rules for operating aid be expanded beyond waste management, energy-saving, renewables, CHP and tax reductions/exemptions, or should the scope be restricted or modified?*

The UK is content with the scope of the provisions on waste management, energy-saving, renewables, CHP and tax reductions/exemptions, subject to the other general comments elsewhere in this response and in the annexed paper.

*Are the percentages for degressive and non-degressive aid appropriate (point 45-46), and is the 5-year period appropriate?*

The UK is broadly content with the concept that operating aid should be digressive over a 5 year period as this should assist in avoiding a culture of aid dependence and the habitualisation of receipt of operating aid in the environmental sector. Where operating aid granted is non-digressive the UK is content that it should normally be applied at 50% of the prevailing aid intensity – subject to our other comments on the calculation of aid intensities and operating costs. However, the revised guidelines should maintain the ability of the Commission to approve such aid at higher than 50% or for longer than 5 years where it can be demonstrated that the particular circumstances relating to the granting of the aid require a higher aid intensity/longer period.

*Should the rules for tax reductions/exemptions be modified to better ensure fair competition between beneficiaries of such aid in different Member States?*

Subject to our general comments and the points below the UK is broadly content with the treatment of tax issues. It would be helpful if the Commission could clarify two issues in any revised guidelines:

- (i) the rules on tax reductions or exemptions should be more flexible to allow Member States to adapt reductions or exemptions already granted, in the light of new information on their effect on the market, competition and the environment<sup>4</sup> and
- (ii) provided all other conditions are met (necessity, proportionality etc), it should be possible to permit new temporary tax reductions from environmental taxes (e.g. the climate change levy) because of a temporary loss of industrial competitiveness in sectors exposed to international competition.

Further, the restrictions in the current guidelines also preclude parliaments from changing the scope of reductions or exemptions, or introducing new ones, following a change of policy. This could occur, for example, on election of a new government. Provided any such reductions or exemptions can be justified as a result of exposure to international competition, it should be possible for them to be allowed.

The UK would also be concerned if the ten-year limit for reductions of environmental taxes (para 51) were retained and it led to sectors being required to pay the full rate of tax in the absence of similar taxes (with similar rates) being introduced in competitor countries. The Commission should review this restriction in the light of the progress (or lack of it) in the development of environmental taxes by the EU's major competitors.

*Are the options for operating aid authorised for renewables aid appropriately defined to encompass the types of aid granted for renewable energy? Is the level of EUR 0,05 per kWh as grant for renewable energy still appropriate (option 3)? Have any decisions been adopted on this basis - if not, should we keep this option? Are the rules defining the possibilities for accepting aid to CHP too restrictive or too lax? Do they correspond to the most recent legislative initiatives from the Community?*

The UK considers that there is a clear need to retain provisions for the granting of aid in this area within the guidelines. However the provisions set out in the current guidelines are overly complex and difficult to operate in practice. The UK considers that they should be simplified

In addition, with the increased use of market based trading schemes to address environmental performance issues the Guidelines should make it clear when tradable permits may amount to state aid and the circumstances in which this may be approved. In particular, it could be stated that trading permits allocated on a "grandfathered" basis will not amount to state aid where this is done on an objective and non-discriminatory basis and the level of tradable permits allowed is proportionate to the level of effort required by the recipient to meet the environmental standard in question.

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<sup>4</sup> The Environmental Guidelines currently only allow derogations in the light of "significant changes in economic conditions that placed the firm in a particularly difficult competitive situation" (para 51(2)(b)).

## ANNEX:

### UK POSITION PAPER ON REVISION OF THE COMMISSION GUIDELINES ON STATE AID FOR ENVIRONMENTAL PROTECTION

#### REFORM OF THE ENVIRONMENTAL GUIDELINES

*This note explains briefly why the EU's Guidelines on State Aid for Environmental Protection ("the Environmental Guidelines") need to be reformed and makes some suggestions as to the changes that are required. First, a few preliminary remarks:*

- (i) We support tight control of distortive state aid: the suggestions here are entirely consistent with the Commission's stated policy of focusing resources on such distortive aid and of taking a more flexible approach to state aid that is generally considered not to have a significant impact on competition. We also support the Commission's attempt to inject more economic and market impact analysis into the assessment of which aids should be approvable. This paper suggests how this might be done in the context of environmental aid.
- (ii) There is a fundamental economic difference between a "pure" subsidy to a company on the one hand and a payment to achieve an environmental objective, **which would not otherwise be achieved** on the other. The Guidelines should recognise that:
  - where companies are not obliged to improve environmental performance and such improvement involves a net cost to the company, state payment of the minimum necessary to secure the improvement will not provide a material advantage to the company receiving the payment and will therefore not significantly distort competition. It will merely offset the non-economic cost to the company of the environmental gain. Such payments are not aid at all if they provide no advantage whatsoever to the recipient. In cases where marginal advantage to the recipient cannot be entirely excluded, the aid should always be approvable, regardless of the location of the investment, as long as the environmental gain is legitimate and the procedures for ensuring that the minimum necessary is paid are sufficiently robust;
  - where companies are subject to environmental regulations (or taxes) which impose costs upon them, this will distort competition unless such regulations/taxes are imposed equally on all their competitors. In practice this is often not the case, so to avoid Member States and the EU as a whole being deterred from introducing such regulations/taxes, the Commission must allow some flexibility for Member States to respond to the additional costs of achieving environmental gains with compensation, especially if that Member State has in practice imposed higher environmental standards than other EU Member States. Such compensation may be pro-competitive, rather than distortive as well as enabling a greater degree of pro-activity by Member States for achieving environmental gain.
- (iii) at all times, no more aid should be permitted than is strictly necessary and this should be in proportion to the objectives sought;
- (iv) the purpose of environmental aid must be solely to achieve European and Member State environmental goals – not to achieve industrial goals. This means that

environmental aid should either be offered to all companies subject to a particular environmental challenge or in a position to achieve the particular environmental gain or be offered through competitive process to those undertakings which can best achieve the environmental gain at the lowest cost.; and

- (v) we recognise that this area is complex and that there may be more than one way of achieving these objectives. What follows are ideas to assist the reform process and the UK would be very happy to discuss them with the Commission.

*Against this background, some of the main reasons for reform are summarised below and, secondly, some suggestions for change are made.*

## **A REASONS FOR REFORM**

These can be grouped under the following broad headings:

### **1 Achieving Environmental Objectives**

The fundamental reason why the Environmental Guidelines need to be reformed as soon as possible is to ensure that environmental support can be given more effectively and to support more global and strategic measures which are vital in the interests of environmental protection and sustainable development. This should not be seen as a radical development as the current Environmental Guidelines state clearly that they are concerned with support for:

- “environmental protection”;
- action to “remedy or prevent damage to our physical surroundings or natural resources”;
- “sustainable development”; and
- “environmental objectives”; and recognise
- the need to “encourage the efficient use of these natural resources”.

However, while these objectives are set out clearly at the beginning of the current Environmental Guidelines, later passages, and the Commission’s interpretation of them, have meant that a number of important environmental initiatives cannot be supported under them. We would particularly refer to three aspects:

#### **(a) Environmental Harms**

“Emissions and pollution” are only one of many sorts of environmental harm: it is vital that Member States should be able to take steps to achieve the above environmental objectives and to tackle other forms of environmental harm by all available means (including state aid where the other pre-conditions for granting aid are met);

#### **(b) Pump Priming**

The current application of the Environmental Guidelines focuses on support to help a company “improve its own environmental record” or “to reduce its own pollution”. This is not always the most efficient way of dealing with an environmental problem – either from a state aid or an environmental policy perspective. It is often more effective to support investments which act as a catalyst and deliver environmental benefits well beyond the point at which the intervention is made in the production cycle. This would allow Member

States to determine the point in the supply/production/services chain where intervention will most effectively be able to incentivise environmental gains along the entire chain: this enables the maximum environmental benefit to be derived from the minimum state intervention and ensuring that no more aid is given than is “strictly necessary” to achieve the objective in question.<sup>5</sup>

**(c) Environmental Benefits**

The Commission’s current interpretation of the Environmental Guidelines ignores many direct and indirect environmental benefits, not just to the recipient of the aid, but to the wider Community (and, indeed, the Member State and the EU as a whole) in terms of a better use of natural resources, reduced emissions of greenhouse gases and other pollutants, increased recycling of waste, reduction and remediation of pollution, reduced landfill etc. etc.

## 2 Minimising Distortions of Competition

As stated above: “the purpose of environmental aid must be solely to achieve European and Member State environmental goals – not to achieve industrial goals. This means that environmental aid should either be offered to all companies subject to a particular environmental challenge or in a position to achieve the particular environmental gain or be offered through competitive process to those undertakings which can best achieve the environmental gain at the lowest cost.”

The current guidelines allow selective assistance of 30 or 40% (or more for small businesses and/or in certain regions) of the net cost of certain environmental enhancements. This is allowed regardless of whether this level of aid is the minimum necessary or not and even if such aid is only given to a sub-set of companies. This may allow Member States to distort competition by making grants available to some firms but not others. It also threatens to distort competition by allowing higher aid in some regions than in others, regardless of whether the firms in those regions require higher aid to achieve the same result.

Arbitrary investment aid limits, especially those which are allowed to vary in this way, are an inappropriate basis for assessing which aids will distort competition contrary to the Community interest and which will not. The Commission should instead focus on ensuring the following:

- That the environmental purpose is valid
- That the environmental purpose would not be delivered by the market by itself (i.e. that there is a market failure)
- That the payment is the minimum necessary to achieve the desired environmental policy objective
- That the aid is offered equally to all companies in the same position

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<sup>5</sup> This is consistent with the EU’s Sixth Environmental Action Programme: “Subsidies can be used in a beneficial way when they are used to pump prime the development of environmentally-friendly processes and products provided they respect the Community state aid rules”.

Any extra support for firms in assisted areas or for SMEs should have to be treated as regional/SME aid and approved separately on this basis.

### 3 Financial Aspects

Excluding innovative and cost-effective schemes from the scope of the Environmental Guidelines could have serious implications from a financing and environmental policy perspective. If Member States cannot support private companies which are prepared to help Member States achieve environmental objectives (often themselves set by the EU or under international obligations), then Member States will have to:

- support only companies which are, in a narrow sense, reducing their own pollution rather than making a wider contribution to achieving environmental goals (as mentioned above, this latter approach will often be more efficient and require less state aid to achieve a given environmental objective – “more bang for your buck”);
- do all the work, and incur all the expenditure itself: i.e. carry out its own R&D, build its own infrastructure etc. This is likely to put unnecessary pressure on state budgets and may, in many cases, be less effective and more distortive of competition;
- amend or dilute their plans so that they fall within other state aid regimes which were not designed for environmental purposes (e.g. regional aid or support for SMEs); or
- fail to meet environmental objectives.

In particular, permitting support for wider environmental objectives would promote “public-private” initiatives (or, put another way, better cooperation between social partners). The Commission has recognised that a public-private partnership approach to environmental issues can be the most efficient from both an environmental and state aid policy perspective.<sup>6</sup>

### 4 Subsidiarity

The Commission has, in many cases, underlined that it is the right of Member States to determine their own public policy. The UK considers that, as noted above, the State aid rules should facilitate that process to the extent that it does not cause unacceptable distortion of the common market. In providing guidance on whether a proposed Member State measure provides an acceptable level of distortion the guidelines should allow the Commission to consider the effects beyond the direct recipient in order to weigh its wider effects and to allow Member States to put in place the most efficient solutions to environmental problems. In this context, we note that:

- environmental policy is a shared responsibility of the EU and Member States and Member States should be free to pursue their own environmental objectives as best suits their own circumstances (as long as this does not conflict with EU law – including state aid law); and
- in many cases where the EU has agreed environmental objectives to be achieved, it is for the Member State to determine the precise manner and

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<sup>6</sup> See, for example, paragraph 3.1.5 of the UK Support for Land Remediation Decision.

the appropriate policy instruments to achieve those environmental objectives<sup>7</sup> (except of course where Member States agree to do this at Community level).

Because environmental policy in the different Member States is varied and because it is also constantly evolving, the environmental aid guidelines need to be capable of accommodating a variety of policy responses across a range of areas and of reacting to innovative policy changes. The current rules are too complex, prescriptive and limitative. The guidelines need to set out the principles according to which aid will be assessed, but leave room for innovative approaches, as long as these do not distort competition contrary to the common interest.<sup>8</sup>

## **5 Support for the Environment**

The UK strongly supports the drive to reduce the total amount of state aid given by Member States. However, it is important that Member States have the possibility to provide state aid in appropriate cases and there may be circumstances, at least in the medium term, where more state aid may need to be given for environmental initiatives given the scale of the environmental problem faced by the Community and the relatively low level of support currently provided.

Reform of the Environmental Guidelines will not, as such, increase the amount of aid given but would simply mean that, where providing targeted support for environmental initiatives was the best method for achieving an environmental objective, this would be classed as Environmental aid. Reform should also assist in reducing the level of aid necessary to achieve a particular environmental effect by facilitating more effective and efficient uses of aid.

Furthermore, it should improve transparency as some aid currently given for environmental reasons is being approved under different measures (e.g. regional guidelines) because of the limitations on the current use of the Environmental Guidelines.

## **B POSSIBLE AMENDMENTS TO THE ENVIRONMENTAL GUIDELINES**

There is much in the existing Environmental Guidelines to support a less restrictive view of them. However, the Commission has clearly felt compelled to take a restrictive view of them. It is therefore important to amend those features of the current Guidelines that have led the Commission to take this approach. The UK believes that the Commission should take a fundamentally different line with the Environmental Guidelines allowing Member States more flexibility of response and assessing proposed measures according to simple economic criteria designed to avoid serious distortions of competition.

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<sup>7</sup> For example, the EC Landfill and EC Packaging directives only set "general targets" for Member States to fulfil (not specific targets binding on individual companies).

<sup>8</sup> While approval of certain aid directly under Article 87(3)(c) in cases such as the UK's WRAP Scheme or Support for Land Remediation is possible, it is clearly preferable that, going forward, aid given for environmental reasons is generally only supported under the Environmental Guidelines. The Commission should ensure that the drafting of any revised guidelines is sufficiently flexible to allow them to accommodate developments within the environmental sector.

The UK believes that where a company is under no obligation to undertake environmental improvement, which is in the broader public interest, and such improvement involves a net cost to the company, the relevant permitted aid intensity should be “the minimum necessary”.

Where companies are subject to a regulatory obligation or environmental tax, helping some of them to meet the cost may at times be necessary to maintain fair competition, depending on the situation of their competitors. The Commission should allow state aid to counterbalance higher environmental standards in order to encourage such higher standards to exist.

In both the above cases the application of arbitrary maximum aid intensities, especially those which vary by region, is inappropriate. Such an approach risks leading to far more aid than is necessary being paid in some circumstances and too little aid being available to meet the environmental challenge in others. It permits selectivity and therefore distortion of competition and the EU does not want to see environmental gain only in its assisted areas.

The Commission should instead focus on ensuring the following:

- That the proposed aid addresses an environmental purpose rather than purely an economic or industrial policy /purpose;
- That the environmental purpose would not be delivered by the market by itself (i.e. that there is a market failure);
- That the payment is the minimum necessary to achieve the objective;
- That the payment is offered equally or competitively to all companies in the same position.

In the UK’s response to the Commission’s “Action Plan” or “roadmap” for State aid reform, we put forward the idea that market impact assessments be conducted for certain types of proposed aid and that decisions on approving notified aids be taken subject to fixed timeframes and on the basis of reviewing whether the proposed measure was likely to seriously distort competition. We suggest that independent competition authorities in the Member States might have a role in advising whether State aid is likely to materially distort competition and/or that third parties be invited to register concern at an early stage to offer further insight over whether distortions of competition were likely. . All this would work particularly well if the Guidelines consisted of largely economic tests such as the above. The UK also considers that there should be scope for some environmental aid to be approved through a block exemption regulation. It should be feasible for the Commission to set out types of aid which have a sufficiently limited distortionary effect that, so long as they meet the criteria in the block exemption regulation, they should not require full prior approval by the Commission. This block exemption approach should be possible whether the Commission adopts the proposals set out in this paper or retains its current approach to aid for environmental protection.

We would also like to suggest some further amendments and clarifications to the Guidelines if they are to continue in anything like their current form. The following suggestions are illustrative of some of our areas of concern.

## 1 Environmental Protection / Sustainable Development.

It should be stated unequivocally that (if the other pre-conditions of the Guidelines are met) support can be provided for any measure or project which is designed to improve “environmental protection” or performance and contribute to “sustainable development” (i.e. not just reduce “emissions and pollution”).

It might also be helpful to set out some (non-exhaustive and purely illustrative) examples of the sort of initiatives which could be potentially supported in the interests of environmental protection/performance and sustainable development but where the market was not sufficiently well developed to allow them to proceed without support. For example:

- making more efficient use of scarce resources (including reduction of energy usage and increasing use of renewables);
- reducing emissions and pollution to air, land and water (including reduction of landfill)
- encouraging the collection and use of recycling materials;
- remediating contaminated or derelict land such that it can be reused;
- preventing and minimising waste, improving waste management; and
- encouraging the development and take-up of new environmental technologies.

## 2 Wider Benefits

Equally, it could be made clear that it is immaterial whether the support improves the environmental record of the recipient or that of a third party or provides environmental benefits for the wider public.<sup>9</sup> As noted above the most effective manner to address an environmental problem may be to support investments which act as a catalyst and deliver environmental benefits beyond the point at which the intervention is made. This would allow Member States to target aid at the point intervention will most effectively create environmental gains along a supply/service chain – enabling maximum environmental benefit to be derived from the minimum state intervention and ensuring that no more aid is given than is “strictly necessary” to achieve the objective in question

## 3 Incentive Effect

It should be made clear that just as support can be provided to help companies meet national environmental standards that are higher than those applicable elsewhere in the EU, if there is no relevant (Community or national) law with which a recipient firm must comply, then support for that company to take environmentally beneficial steps should be allowable (provided it has a clear incentive effect).<sup>10</sup> It should be clear that a company should not be precluded from receiving state aid under the Environmental Guidelines merely because, in doing so, this

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<sup>9</sup> The Commission recognised this clearly in paragraph 73 of the WRAP Scheme decision where it stated that it was proposing to amend the Guidelines to include “environmental benefits at the global level of the Member State or the Community, and not [just] at the individual level of the beneficiary”.

<sup>10</sup> It is clear that aid should only be granted to assist the implementation of environmental improvements which would not occur spontaneously (or even for some period of time) through existing market forces – otherwise there is no incentive effect.

helps a Member State, or the Community as a whole, achieve some environmental objective.  
<sup>11</sup> This is immaterial to the company receiving the payment and therefore not a relevant consideration when assessing to what extent a payment distorts competition. Because Member State compliance with environmental laws must be in the Community interest, such a factor should make any aid more, rather than less likely to be approved.

#### **4 Polluter Pays**

We strongly support the “polluter pays” principle but the Environmental Guidelines need to recognise that there are limits to the concept of cost internalisation in the context of environmental issues, especially where a more environmentally-beneficial approach is not mandatory. For example, it is not clear that a producer should be required “to internalise” the environmental costs of his current choice of, for example, virgin raw materials, rather than recycled raw materials.<sup>12</sup> There are also situations where, even though costs may be internalised, it may still be appropriate to permit state aid under the guidelines – for example, to stimulate new technology.

#### **5 State of the Art**

It should be clear that support for environmental objectives should not be precluded where the process/approach/technology being supported is not yet the state of the art: i.e. its use is not yet the norm and is unlikely to be so in the medium term (e.g. within two or three years) without some form of intervention – e.g. by the use of state aid.

It should also be clear that support can be given to help environmental technologies move forward from niche applications towards mainstream and/or state of the art (e.g. cleaner production, the use of more energy-efficient goods, use of renewable technologies, or the production of goods with higher recycled contents). This would include support for demonstration equipment and demonstration facilities.

#### **6 Investment Aid / Operating Aid**

The rules governing investment aid for the environment (and for waste management and energy saving in particular) should be at least as favourable as those governing operating aid for these purposes. In the WRAP Scheme decision, the Commission noted that paragraphs 42 to 46 of the existing Environmental Guidelines, dealing with aid to promote waste management and energy saving, deal only with “operating” aid, and could not be used to justify “investment” aid. In a narrow sense, this may be legally correct but, from an environmental and state aid policy perspective, it would seem to be the wrong way round:

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<sup>11</sup> This seems consistent with paragraph 21 of the existing Environmental Guidelines, which explains that it is not necessary to provide aid to firms merely to “encourage them to obey the law”. However, there is clearly room for different views here as the Commission has used paragraph 29 of the Environmental Guidelines as the basis for not applying the Environmental Guidelines even where the only obligation was at the Member State level (cf paragraphs 37 and 56 – 58 of the WRAP Scheme decision). In these circumstances, it is appropriate to clarify paragraphs 20, 21, 29 and 40 of the Environmental Guidelines (all of which touch on this subject and which are internally inconsistent).

<sup>12</sup> The producer should not be seen as the “polluter” in these circumstances. Furthermore, there is no need to view the producer as a polluter once it is accepted that the Environmental Guidelines can permit support for measures designed to achieve global objectives, rather than simply reducing on-site pollution (cf point B.2 above).

generally, state aid policy is (quite rightly) more restrictive in relation to operating aid than investment aid.

## **7 Eligible Costs**

Some clarification of point 37 of the Environmental Guidelines would be helpful. In particular, this point tends to lead to an approach which looks to compare the costs of an environmentally friendly investment, with the cost of an environmentally “unfriendly” project. While, in some cases, this would be appropriate, in many cases it will not (because there is no “unfriendly” comparator). As the Commission has recognised in a number of cases,<sup>13</sup> this approach is not required by paragraph 37 and refocusing the paragraph would therefore be welcome. We would make three comments/suggestions on this:

- the “minimalist” approach to such a clarification might simply entail deleting the word “extra” in the first paragraph of paragraph 37;
- the Guidelines should allow support for investments which compensate for environmental “externalities”. For example, the rules on operating aid for renewable energy in section E.3.3 (Option 3, para 63) of the Environmental Guidelines allow aid to be calculated on the basis of the avoided external costs (in effect, the real environmental benefits of the investment or the cost of the market failure). There is no reason, in principle, why this approach should only be confined to renewable energy – it could equally well apply to other environmental technologies, including resource efficiency investments such as those designed to establish recycling capacity; and
- the costs would be eligible up to the lesser of the cost of the extra cost of the environmentally “friendly” technology or the cost of the avoided external costs.

## **8 Aid Intensity**

The Commission should reconsider the effective allowable percentages at which interventions can be made under the guidelines in the light of changes in markets and technologies. The UK would prefer the maximum permitted aid intensity for environmental aid to be “the minimum necessary”, as explained above, but even if the Commission does not accept this, the current system still needs reform.

While the maximum aid intensities provided under the guidelines of around 30-40% may seem appropriate and in line with the intensities allowed in other horizontal frameworks, this gives a misleading view of the actual aid intensities which are allowable. The restriction to aiding purely marginal environmental costs of a project actually leads to aid intensities which are significantly lower than the nominal figures. In many cases the effective maximum level of aid allowed under the Environmental Guidelines may simply be insufficient to allow a project to go ahead.

In particular, where the aim of a measure is to address a market or financing failure in an environmental market (rather than “greening” an existing market’s activities) the model described above and in section 7 breaks down. The amount of aid needed depends on the scale of the market failure and because these are multiple and varied across the entire

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<sup>13</sup> E.g. in the *WRAP Scheme* decision or in the *Photovoltaic* decision.

environmental field, fixed percentages cannot hope to be flexible enough for purpose. This has been demonstrated in the difficulty which the Commission has had in approving entirely reasonable and proportionate Member State schemes within the scope of the guidelines.

There should be scope for wider environmental effects to be taken into account in the consideration of a proposed aid: in particular, schemes which support activities which will have a wider effect across a market to produce an environmental benefit (or a number of environmental benefits).<sup>14</sup> If aid is particularly beneficial, some small distortions of competition may be an acceptable price to pay.

If, despite this paper, the Commission retains regional aid-style maximum aid intensities, at the very least, it should be possible for the Commission to re-consider the way in which the eligible costs to which the aid intensities apply are calculated. For example, as noted above, no account is taken in the current guidelines of environmental effects beyond the direct recipient of the aid. This should be included within any future guidelines. Furthermore, as noted above, the model on which the calculation of marginal environmental costs is based is no longer sufficient to cover the range of projects for which approval is sought under the guidelines. Many current aid schemes, particularly those which are designed to remedy market failure to achieve the desirable environmental outcome and offer the minimum necessary to achieve that objective can be argued to contain little or no “non-environmental” element and, therefore, all their eligible costs should be able to be considered for funding. The revised guidelines should deal with such a possibility.

If the Commission considers that this is not possible then there may be other ways to ensure that there is sufficient scope to provide levels of aid sufficient to incentivise improved environmental performance. For example, an approach along the following lines could be adopted. It may be possible to increase the aid intensity which may be applied to the marginal environmental costs of a project to a higher level – say 50-60% - while retaining a provision that no aid may be granted above 30% of the total eligible costs of the project. This would provide for higher levels of aid where necessary while retaining discipline on overall levels of aid. It should be emphasised again, here, that the UK believes that even under such arrangements, no more aid should ever be permitted that that strictly necessary to achieve the objective in question and additionality should be demonstrated in all cases.

## 9 Tax Issues

It would also be helpful to clarify two tax issues:

- (i) the rules on tax reductions or exemptions should be more flexible to allow Member States to adapt reductions or exemptions already granted, in the light of new information on their effect on the market, competition and the environment;<sup>15</sup> and

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<sup>14</sup> For example, an investment in a recycling facility will have a direct benefit that recycling of a particular product will increase. However, the project may also be configured to achieve other important environmental effects as second or third-order effects – for example, an increase in use of waste feedstock will remove material from landfill, increase efficient usage of existing natural resources and the arrangements for collection of the waste feedstock may create sufficient critical mass to incentivise the collection and recycling of other materials etc

<sup>15</sup> The Environmental Guidelines currently only allow derogations in the light of “significant changes in economic conditions that placed the firm in a particularly difficult competitive situation” (para 51(2)(b)).

- (iii) provided all other conditions are met (necessity, proportionality etc), it should be possible to permit temporary tax reductions from environmental taxes (e.g. the climate change levy) because of a temporary loss of industrial competitiveness in sectors exposed to international competition. An example of this would be new discounts for energy-intensive sectors under the climate change levy where new information has revealed competitiveness problems which had not originally been anticipated.

## **10 Tradeable Permits**

The Guidelines should make it clear when tradeable permits may amount to state aid and the circumstances in which this may be approved. In particular, it could be stated that trading permits allocated on a “grandfathered” basis will not amount to state aid where this is done on an objective and non-discriminatory basis and the level of tradeable permits allowed is proportionate to the level of effort required by the recipient to meet the environmental standard in question.

## **11 Further Safeguards**

In amending the Environmental Guidelines, the Commission (and some Member States) will, quite rightly, be concerned not to open the floodgates to excessive or inappropriate aid. This is not the intention of the proposed reforms and, to allay concerns, it may be helpful to build in some further safeguards and/or to re-affirm or clarify some existing principles. The following are some examples/suggestions:

### **(a) Polluter pays**

With an appropriate qualification (see point B.4 above) re-affirm the “polluter pays” principle.

### **(b) Legal obligations**

It could be re-emphasised that state aid should not generally be available merely to help the recipient meet a legal obligation applicable to that recipient, unless its competitors are not subject to similar obligations. If a Member State proposes to offer aid to help companies meet EU-wide obligations, the presumption would be that such aid was unwarranted, but there could be exceptions if a Member State hosting a major competitor had manifestly failed to apply the EU rules correctly, for example, or if a company primarily faced non-EU competition and all other Member States hosting competitors were not opposed to such aid being granted.

### **(c) Necessity**

It could be confirmed that state aid should only be permissible under the Guidelines where this is “necessary” from an environmental perspective. This could include showing, at the time of granting the aid, that the market will not support activities leading to environmental benefits and, as a result, the project being supported is not currently economically viable; For example, this might be the case where a project involves:

- (a) supporting innovation and new process and technology developments (establishing new technologies, e.g. pilot plants, demonstration activities and, where appropriate, full production facilities);
- (b) supporting existing technology which has not yet been proven for use in novel applications or for new markets or new material;
- (c) encouraging the development of new end-uses or markets for existing materials;
- (d) supporting technology transfer where technology has been proven elsewhere in the world but for which market failure is preventing its development here; and
- (e) facilitating the development of new recycling capacity where the principal purpose of the project is environmental (and not industrial).

Further relevant factors to help demonstrate the aid is necessary to achieve environmental objectives could include showing that:

the body giving the aid is a bona fide environmental body with environmental objectives;<sup>16</sup>

- examples of the scheme or measure in question show that they are directed to environmental, and not solely industrial, objectives;
- the objectives of the proposed investments are in line with EU policy on the environment;<sup>17</sup>
- no more aid is given than is necessary to meet that environmental purpose. Again, this can be demonstrated in a variety of ways but relevant factors could include showing that the criteria for selecting companies/projects were open, transparent and non-discriminatory.

#### **(d) Proportionality**

Confirm that the principle of proportionality must, in all cases, be respected. For example, show that every effort has been made to off-set and reduce any potential adverse effects on competition.

End

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<sup>16</sup> Although it should not be limited to this as, obviously, public bodies with a wider mandate may give support wholly, or primarily, for environmental purposes.

<sup>17</sup> This should not be the only way in which the environmental objectives can be demonstrated as Member States are entitled to pursue environmental objectives different, or going beyond, Community environmental objectives (as long as they do not conflict with Community law).