

The European emission trading scheme put to the test of state aid rules¹

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The European Union emissions trading scheme (EU ETS) was launched in 2005 to cap CO₂ emissions from energy-intensive industry.² Its aim is to secure emission reductions at the lowest possible overall cost. The key feature is the allocation process, which determines the reduction target within each Member State ('cap') and the way allowances are distributed among the covered operators. There are two distinct phases of allocations, the first running from 2005 to 2007 and the second from 2008 to 2012. For each trading period, Member States had to set up a national allocation plan (NAP), which had to be submitted to the Commission for approval.³ Contrary to other emission trading systems, Member States were conferred a considerable degree of freedom to fix the caps and to decide the amount of allowances to be allocated to each installation. The main restriction was that at least 95% of the allowances had to be allocated for free in the first and 90% in the second trading periods.⁴

Most Member States chose to distribute all their allowances for free.⁵ For existing installations the amount of allowances was usually calculated according to historical emissions or expected needs, whereas new entrants were granted allowances with regard to certain benchmarks.⁶ Special rules were set out for closures, early action or co-generation. As a result, a wide variety of allocation rules existed, leading to considerable distortions of competition. The latter were exacerbated by a phenomenon called 'windfall profits', which significantly increased the benefits of certain operators, especially CO₂-intensive installations in the power sector that had received the lion's part of the allowances. The reason for these extraordinary profits is that many of these firms could

¹ This paper is an updated short version of a paper published in 2007 by the author. See *The European Emission Trading Scheme Put to the Test of State Aid*, NCCR WP 34/2007 at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1088716

² See the Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC. Hereafter the 'Directive'.

³ Article 9 of the Directive.

⁴ Article 10 of the Directive.

⁵ See Joëlle de Sépibus, *Scarcity and allocation in the European Emissions Trading Scheme – A legal analysis*, NCCR Working Paper 2007, n. 32 (available at <http://www.nccr-trade.org/ip-1/>); Denny Ellerman, Barbara Buchner, Carlo Carraro, *Unifying themes*, Denny Ellerman Buchner K. Barbara, Carraro Carlo, Allocation in the European Emissions Trading Scheme, Cambridge, 2007, p. 339-369.

⁶ As new operators have no historical record, the allocation of allowances must be made according to a certain benchmark, which may be fuel-, technology- or output-related.

largely pass on the price of the allowance to their customers, even though they had been granted the allowances for free.⁷

The question thus arose whether the large economic rents conferred on certain big players, in particular in the power industry, amounted to state aid prohibited by Article 87 EC Treaty⁸. We shall try to answer this query by examining how the Commission addressed this issue when assessing the NAPs and discuss whether its approach is in line with the case law. The study of this question is of particular interest as the debate regarding the state aid character of gratuitous allocation of allowances has reignited with respect to the third trading period of the EU ETS.⁹ Its relevance is, however, not limited to Community law. Indeed, many countries, such as the United States, Australia and Japan, which are about to implement emission trading schemes, will have to deal with this issue, as they are bound by the Agreement on Subsidies and Countervailing Measures (ASCM)¹⁰, which establishes a regime bearing many similarities with the provisions of the EC Treaty.

2. The prohibition of state aid (Article 87 par. 1 EC Treaty)

Art. 87 EC Treaty ('EC') bans any State aid granted by Member States unless it complies with the derogations provided for it by the Treaty.¹¹ Generally it is incumbent on the Commission to verify whether the aid meets the conditions that might exceptionally justify its grant. Member States are hence requested to notify any aid to the Commission and await its decision before implementing it.¹²

The definition of State aid is laid down in Article 87 par. 1 EC Treaty. The following conditions must be fulfilled. First, there must be an intervention by the State or through State resources.¹³ Second, the measure must confer a selective advantage on the recipient. Third, the measure must distort or threaten to distort competition. Fourth, the intervention must be liable to affect trade between Member States.

2.1 The financing by the State or through State resources

⁷ See Michael Grubb, Karsten Neuhoff, *Allocation and Competitiveness in the EU Emission Trading Scheme: Policy Overview*, Climate Policy, 2006, v. 6, p. 14.

⁸ The Treaty of the European Communities.

⁹ European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading system of the Community, COM(2008) 16.

¹⁰ The ASCM belongs to the Agreements adopted in the framework of the World Trade Organisation (WTO).

¹¹ See for instance Articles 87 (2) and (3) and 88 and 89 EC Treaty.

¹² See Article 87 (3) EC Treaty.

¹³ See Case C-280/00, *Altmark Trans GmbH v Regierungspräsidium Magdeburg*, 24.7.2003, par. 75.

Aid must be imputable to the State and be granted directly or indirectly through State resources.¹⁴ When assessing the NAPs, the Commission consistently held that this condition was fulfilled if more than the mandatory amount of allowances was granted for free¹⁵ and if banking¹⁶ was allowed.¹⁷

According to the case law the decision of a Member State to grant aid must be unilateral and autonomous, which is excluded if a Member State merely implements its “obligations stemming from the Treaty”.¹⁸ From this follows that unless Article 10 of the Directive is at variance with the Treaty the decision to allocate 95% respectively 90% of allowances for free is not imputable to Member States. The existence of a Community obligation does, however, not prevent the measure from being qualified as aid if the State keeps some discretionary power.¹⁹ Accordingly, to the extent that the Directive leaves some discretion to Member States regarding the allocation process, the latter remains imputable to them.

The notion of State resources includes not only the direct or indirect transfer of State resources to an undertaking, but also the waiving of revenue, which would otherwise have been paid to the general budget.²⁰ This is not the case if the financial burden of a measure relies exclusively on private undertakings.²¹ Many authors challenge the State aid character of the grant of gratuitous allowances on the ground that as there is no general rule which makes the payment for CO2 emissions compulsory and that, conversely, a decision to allocate allowances for free doesn't amount to a waiver of state revenues. They argue, moreover, that the benefits accruing to the operators selling emission allowances derive directly from the market and thus cannot be attributed to the State. These arguments are, however, at odds with the fact that the proceeds result from the sale of allowances, which were created by the State and that the polluter pays principle commands the polluter to internalise its costs.²²

2.2 The existence of a selective benefit for an undertaking

The transfer of State resources must confer an economic advantage on the recipient undertaking.²³ The Commission takes the view that this condition is fulfilled if

¹⁴ Case C-482/99, *France v Commission*, 16.5.2002.

¹⁵ See European Commission, Decision on the second Slovakian NAP, 29.11.2006.

¹⁶ ‘Banking’ means that allowances issued for one compliance period may be used by the recipient in a later compliance period.

¹⁷ European Commission, Decision on the first Danish NAP, 7.7.2004.

¹⁸ Case T-351/02, *Deutsche Bahn v Commission*, 5 April 2006.

¹⁹ Dony Marianne, *Contrôle des aides d’Etat, Droit communautaire de la concurrence*, Editions de l’Université de Bruxelles, 3^{ème} édition, Commentaire J. Mégret, volume 2, 2007, Bruxelles, p. 30.

²⁰ Case T-67/94, *Ladbroke Racing v Commission*, 27.1.1998, par. 109.

²¹ Case C-379/98, *PreussenElektra v Commission*, 13.3.2001.

²² See Article 174 EC Treaty.

²³ Case C-280/00, *Altmark Trans GmbH v Regierungspräsidium Magdeburg*, 24.7.2003, par. 84.

allowances are granted for free.²⁴ Some authors oppose this interpretation, arguing that the revenue accruing from the price received for the allowances constitutes the legitimate counterpart for the costs incurred in reducing these emissions.²⁵ Against this argument militates however the fact that the revenues in many cases exceed the costs and that the ‘windfall profits’ accrue to the operator without any environmental counterpart.²⁶

An economic benefit granted by a Member State constitutes State aid only if it displays a certain degree of selectivity.²⁷ In its assessments, the Commission did not question seriously the selectivity criterion, once an advantage was established. In the case law, this condition entails to verify whether the methods of allocation adopted by Member States favoured certain undertakings in comparison with others that are in a comparable situation in the light of the objective pursued.²⁸

Due to the large discretion left to Member States the amount of allowances allocated to the covered installations varied significantly between sectors but also within comparable categories of undertakings. As a result, the allocation rules largely favoured certain undertakings at the expense of others, in particular existing operators with respect to new entrants and CO₂-intensive with respect to less emitting installations.²⁹ These effects were exacerbated in the power sector, where cost abatement differentials are important and operators could largely pass on the price of the allowances to their costumers.³⁰ The justification generally advanced for privileging existing over new installations was that it ensured that operators had to be compensated for the impact of unforeseeable environmental regulation at the time of their construction. Arguably, such a distinction may hardly be justified in the light of the objective pursued by the EU ETS.

2.3 Distortion of competition and effects on trade between Member States

Article 87 par. 1 finally provides that aid must distort competition and affect trade between Member States. These two conditions are generally considered as fulfilled if the financial aid strengthens the position of an undertaking compared with other undertakings

²⁴ See European Commission, Decision on the first French NAP, 20.10.2004, par. 5.

²⁵ See Walter Frenz, *Bestandsschutz im Emissionshandel*, *Recht der Energiewirtschaft*, 2007, v. 3, p. 69. Carl-Stephan Schweer, Bernhard Ludwig, *Emissionshandel und EG-Beihilfenrecht*, *Recht der Energiewirtschaft*, 2004, vol. 7, p.155.

²⁶ See Angus Johnston, *Free Allocation of allowances under the EU Emissions Trading Scheme- Legal issues*, *Climate Policy*, 2006, v. 6, p. 119.

²⁷ Case C 143/00, *Adria-Wien Pipeline and Wietersdorfer & Peggauer*, 8.11.2001.

²⁸ Case C-88/03, *Portugal v Commission*, 6.9.2006, par. 54.

²⁹ Regina Betz, Karolin Rogge, Joachim Schleich, *EU emissions trading: an early analysis of national allocation plans for 2008-2012*, *Climate Policy*, 2006, v. 6, n. 4, p. 361-394.

³⁰ Karsten Neuhoff, Markus Åhman, Regina Betz, Johanna Cludius, Federico Ferrario, Kristina Holmgren, Gabriella Pal, Michael Grubb, Felix Matthes, Karoline Rogge, Misato Sato, Joachim Schleich, Andreas Tuerk, Claudia Kettner, Neil Walker, *Implications of announced phase II national allocation plans for the EU ETS*, *Climate Policy*, 2006, v. 6, p. 411-422.

competing in intra-Community trade.³¹ Applied to the EU ETS, this means that any allocation methodology, which favours unduly some undertakings at the expense of others is likely to distort competition and to affect trade. In its review of the NAPs the Commission generally considered both criteria as fulfilled.³²

3. The derogations of the prohibition of State aid (Art. 87 par. 3 EC)

The Commission enjoys a wide, but not unlimited discretion when evaluating the compatibility of State aid with the common market.³³ It has to examine whether the aid is appropriate to meet one of the objectives mentioned in Article 87 par. 3 EC Treaty and to weigh the beneficial effects of the aid against its adverse effects on trading conditions and the maintenance of undistorted competition.³⁴

When appraising the NAPs, the Commission did not conduct a formal state aid investigation, but limited its assessment to provisional evaluations. It primarily verified whether the Member States distributed more allowances than needed to their installations.³⁵ With respect to the second phase, it considered this condition as fulfilled if the caps set by Member States violated criteria 1-3 of Annex III of the Directive³⁶, if individual installations were given more than they needed and if the information provided by Member States was purely subjective. Extending its analysis to specific allocation methodologies, it held, moreover, a German³⁷ and a Polish³⁸ allocation rule incompatible with the common market as the former discriminated between comparable installations and the latter used a non representative baseline with respect to average emissions of installations.

The principles established by the Commission when appraising the NAP were by and large confirmed in the recently adopted 'Community guidelines on state aid for environmental protection'³⁹, which provide the basis for the Commission's assessment until the end of 2012. The Commission declares therein that emission trading schemes may involve State aid in various ways, for example, when Member States grant allowances below their market value. It clarifies that this type of aid may be justified if it allows such schemes to be introduced and if caps are lower than the global expected needs of undertakings and no case of individual over-allocation can be detected.

4. Conclusions

³¹ See Case T-298/97, *Alzetta v Commission*, 15.6.2000, par. 81.

³² European Commission, Decision on the second German NAP, 29.11.2006, par. 22-25.

³³ See Case T-380/94, *AIUFFASS and AKT v Commission* [1996] ECR II-2169, par. 56.

³⁴ Joined Cases T-371/94 and T-394/94, *British Midland Airways vs Commission*, 25 June 1998, par. 282 and 283.

³⁵ European Commission, Decision on the first French NAP, 20.10.2004, par. 5.

³⁶ See European Commission, COM (2006) 725 final.

³⁷ European Commission, Decision on the second German NAP, 29.11.2006.

³⁸ European Commission, Decision on the second Polish NAP, 26.3.2007, par. 23.

³⁹ Official Journal C 82 of 1.4.2008, p. 1.

Despite evidence accumulating that the EU ETS has conferred large economic rents on CO₂-intensive operators, reducing thereby the economic efficiency of the scheme, the Commission has used its powers under the state aid provisions parsimoniously. So far, it has only taken provisional decisions, in which it addressed clearly discriminatory rules and the most patent cases of over-allocations. Quite surprisingly, it considers that the free allocation of allowances is compatible with the common market if the amount of allowances does not exceed expected needs, though this amounts to sanctioning business-as-usual practice.

The reasons for this cautious approach are manifold. Arguably, the most important is that the Commission feared that a tough observance of the state aid rules would put at risk the introduction of the scheme. Moreover, the Commission had neither the staff nor the time to carry out more than superficial evaluations.⁴⁰ Finally, as nearly all Member States used 'expected needs' as their principal reference for allocating allowances to existing installations, the denunciation of this mode of allocation would have been politically sensitive.

The Commission's concern of ensuring a smooth functioning of the scheme can also be witnessed in its practice regarding complaints of affected operators. As the case *EnBW v Commission*⁴¹ shows, the endeavour to challenge an allocation rule the Commission has evaluated positively in its NAP decision is fraught with difficulties. In casu, the Commission merely informed the plaintiff, an operator of a nuclear power station, in a so-called 'service-letter' that there were "insufficient grounds" for opening a state aid procedure, thus depriving the plaintiff from challenging its act.⁴²

The fear that the Pandora's box might be opened if operators were given the right to challenge an allocation rule that has been provisionally approved by the Commission, seems to be shared by the Court of First Instance. By considering that *EnBW* lacked an interest in the annulment of the Commission's decision on the German NAP⁴³ inasmuch as the latter had not rejected it, the court effectively forestalled any legal action aiming at challenging an allocation method the Commission has *prima facie* considered compatible with the rules on State aid. As a result, the Commission remains the sole gatekeeper of the state aid rules and it will principally depend on its willingness and political clout to stop the massive "windfall" profits of certain operators that jeopardise the environmental effectiveness of the EU ETS.

⁴⁰ See Peter Vis, *The first allocation round: a brief history*, Jos Delbeke, EU environmental law, Claeys & Casteels, Leuven, p.202.

⁴¹ See Case T-387/04, *EnBW Energie Baden-Württemberg AG v Commission*, 30.4. 2007, par. 41 ff.

⁴² To be challengeable, the letter must come from the College of the Commissioners and be addressed to the Member States, which was not the case here. See Article 25 of Council Regulation No 659/1999.

⁴³ See Case T-387/04, *EnBW Energie Baden-Württemberg AG v Commission*, 30.4. 2007.

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