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The European Emissions Trading Directive: The End of the Beginning, the Beginning of the End or Somewhere in Between?

Laura Atlee and Simon Van Cutsem*

At this stage, it is too early to make final considerations on the merits and impacts of the functioning of the scheme.[1]

I. Introduction

The Independent recently published a comment by Dr. James Lovelock in which the environmental scientist proclaimed that civilization is 'in grave danger.'[2] He is of the opinion that throughout this century the temperature will rise by 8°C in temperate regions and 5°C in tropic regions. Dr. Lovelock has concluded that if countries such as the United States, China and India do not reduce their emissions, it is improbable that global warming and the resulting adverse effects can be reduced. While these countries have resisted reining in their emissions, the European Union ('EU'), comprised of 25 Member States, is changing its behaviour, and quickly. The EU's climate change policy includes many measures in various forms,[3] but one piece of environmental legislation that currently attracts a lot of attention is the Emissions Trading Directive (the 'EU ETS Directive').[4]

The EU Emissions Trading Scheme ('EU ETS') became active on 1 January 2005, although the years and months leading up to the official start of the trading system were anything but sedentary, and it is unlikely that there will be a moment's rest for years to come. The European Institutions, Member States, industries, traders, scientists, brokers, non-governmental organizations ('NGOs'), even ordinary citizens, are involved in the EU ETS in some capacity. Everyone is drafting legislation, guidelines, position papers, scientific reports, financial reports, futures contracts, and/or engaging in over-the-counter trading and the system is just getting started.

Arguably, those bearing the heaviest burdens are the industries whose emissions are subject to the EU ETS Directive. Until now, only emissions from specific sectors of the industry have been covered, but additional sectors, including transport, aluminium and chemicals, may be included in subsequent phases.[5] The industries that are likely to see the greatest increases in energy costs (approximately 1 per cent in relation to sales[6]), are:

- starch products;
- malt;
- paper and paperboard;
- industrial gases;
- inorganic and organic chemicals;
- fertilizers;
- bricks;
- cement;

Notes

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1 Council of the European Union, *Reply to Written Question E-3443/05 put by Eija-Riitta Korhola*, (PPE-DE), 9 March 2006.

2 'The Earth is about to catch a morbid fever that may last as long as 100,000 years', *The Independent*, 16 January 2006.

3 Approximately 42 according to Commissioner Dimas, Question and Answer Session at 'Green Week' (31 May 2005).

4 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, [2003] OJ L275/32 (hereinafter: the 'EU ETS'), as amended by Directive 2004/101/EC, [2004] OJ L338/18.

5 Ibid., at Recital 15 and Art. 30(2)(a). The European Commission is currently contemplating including aviation in the EU ETS, *see Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions: Reducing the Climate Change Impact of Aviation*, (COM(2005) 459 final) p. 10.

6 *Competitiveness, Trade and Regional Implications of EU Emissions Trading Scheme* (available at: <http://www.dti.gov.uk/energy/sepn/euetsimplications.pdf>).

- iron and steel;
- aluminium and lead;
- zinc; and,
- tin.

Climate change, and especially the EU ETS, will certainly remain a high priority on Europe's agenda. The emissions scheme is likely to grow both literally and political, over the coming years. [7]

At the moment it is unclear what will happen after 2012, when the Kyoto Protocol expires. The United Nations Climate Change Conference closed on 10 December 2005 in Montreal with no agreement on the involvement of non-Kyoto signatories such as the United States. Negotiations on the new targets will likely linger until 2008. However, the EU Commissioner responsible for the Environment noted optimistically, 'The EU will continue to take the initiative in drawing more countries into the process launched in Montreal. This is just the end of the beginning.'[8] Some environmentalists applaud these initiatives; others grumble that the EU should not be so self-congratulatory. Some industries raise eyebrows, wondering if this entire system will come crashing down; others see it as an opportunity to promote the environmental friendliness of their business practices and make a couple of euros, too. Whether or not the EU ETS is here to stay, it is here now.

II. International Framework

The EU ETS is supposed to be a rehearsal for the big show beginning in 2008 at which time an international emissions scheme will begin functioning as part of the Kyoto Protocol to the United Nations Framework Convention on Climate Change (the 'Kyoto Protocol'). The EU formally approved the Kyoto Protocol in May 2002, and the agreement came into force for all signatories on 16 February 2005.[9] The press has been kind enough to point out repeatedly, possibly *ad nauseum*, the fact that the United States has not ratified the Kyoto Protocol.[10]

The Meeting of Parties ('MOP'),[11] comprised of 155 countries, agreed to the Kyoto Protocol. However, only the 36 industrial nations have agreed to an overall reduction of 5 per cent below 1990 greenhouse gases ('GHG') emission levels.

The EU, as one entity, has committed itself to reducing its GHG emissions under the Kyoto Protocol for the 15 'old' EU Member States. The EU-15 committed itself to reducing its GHG by 8 per cent from base year level (emissions in 1990 for CO_2, CH_4 and N_2O, but 1995 for fluorinated gases) for the years 2008-2012. The combined effort is known as the 'burden sharing agreement.'[12] Within the burden sharing agreement, Member States have individual commitments (shown as a percentage of the base year value):

- Austria: 87%;
- Belgium: 92.5%;
- Denmark: 79%;
- Finland: 100%;
- France: 100%;
- Germany: 79%;
- Greece: 125%;
- Ireland: 113%;
- Luxembourg: 72%;
- Netherlands: 94%;
- Portugal: 127%;
- Spain: 115%;
- Sweden: 104%; and,
- United Kingdom: 87.5%.

As is evident, certain Member States may emit more GHG than in 1990 and 1995 for the respective gases. However, it does not necessarily mean that they may emit more GHG in absolute terms. For example, Spain's emissions must only be 15 per cent greater than the

Notes

7 The Austrian Presidency of the Council of the European Union, and the Finnish Presidency in the Spring, note in their operational programme that climate change will 'remain a high priority on the Council's agenda' and '[d]epending on the Commission timetable for a legislative proposal on Aviation Emissions the Council will start the discussion on' the dossier. Operational Programme of the Council for 2006 submitted by the incoming Austrian and Finnish Presidencies (16065/05). *See also Commission Staff Working Document, Annex to the: Communication from the Commission 'Reducing the Climate Change Impact of Aviation' Impact Assessment* (SEC(2005) 1184); Currently only CO2 emissions from domestic flights are included in obligations imposed on certain Parties to the Kyoto Protocol; the EC notes, '[I]nternational flights are dealt with separately just as a "memo item".'

8 *Climate Change: Successful conclusion of UN conferences in Montreal*, statement by Environment Commissioner Stavros Dimas (MEMO/05/473) on 11/12/2005.

9 Council Decision [2002/358/EC] of 25 April 2002 concerning the approval, on behalf of the European Community, of the Kyoto Protocol to the United Nations Framework Convention on Climate Change and the joint fulfilment of commitments thereunder, [2002] OJ L130/1.

10 Australia also refused to ratify the Protocol. Developing countries, such as China and India, are not bound by emission reductions.

11 As opposed to the Conference of Parties ('COP'), approximately 190 countries that are bound to the 1992 *United Nations Framework Convention on Climate Change* ('UNFCCC'), which entered into force on 21 March 2004.

12 Council Decision 2002/358/EC, as note 9 above.

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base year level. However, for 2003 its emissions were 40.5 per cent higher than its base year.[13] The specific commitments ensure that if the EU-15 does not meet the joint reduction of 8 per cent for 2008-2012 that Member States continue to strive to meet their individual obligations.

The 10 'new' Member States have their own, individual commitments to reduce GHG emissions, excluding Malta and Cyprus, which have no obligations under the Kyoto Protocol. The new Member States have the following individual commitments under the Kyoto Protocol:

- Czech Republic: 92%;
- Estonia: 92%;
- Hungary: 94%;
- Latvia: 92%;
- Lithuania: 92%;
- Poland: 94%;
- Slovakia: 92%; and,
- Slovenia: 92%.

III. EU ETS Directive

The EU ETS Directive aims to contribute to fulfilling the commitments of the EU and its Member States more effectively, 'with the least possible diminution of economic development and employment.'[14]

The system is based on emission allowances called European Union Allowances ('EUAs'). One allowance is equal to the right to emit one tonne of CO_2. The entire system is capped, as the total number of allowances in the system is limited.

At the beginning of each Phase (i.e. Phase I is 2005-2007 and Phase II is 2008-2012), each installation falling under the EU ETS Directive is allocated a certain number of allowances for free.[15] The number of allowances allocated to an installation may or may not cover the tonnes of CO_2 it emits throughout the year. If an operator of an installation believes that it will be short, it can buy additional allowances, change its means of production to decrease the tonnes it emits, and/or participate in Kyoto Flexible Mechanisms as discussed below.

Box 1. The system is designed to ensure that the cheapest reductions are made first.

Let's say that companies A and B both emit 100,000 tonnes of CO_2 per year. The government gives each of them 95,000 emission allowances. One allowance represents the right to emit 1 tonne of CO_2. So, neither company is fully covered for its emissions. At the end of each year, the companies have to surrender a number of allowances corresponding to their emissions during the year, whatever the emissions of the individual company are. Companies A and B both have to cover 5,000 tonnes of CO_2, and they have two ways of doing this. They can either reduce their emissions by 5,000 tonnes, or purchase 5,000 allowances in the market. In order to decide which option to pursue, they will compare the costs of reducing their emissions by 5,000 tonnes with the market price for allowances.

For the sake of the example, let's say that the allowance market price is € 10 per tonne of CO_2. Company A's reduction costs are € 5 (i.e. lower than the market price). Company A will reduce its emissions, because it is cheaper than buying allowances. Company A may even reduce its emissions by more than 5,000 tonnes, say 10,000 tonnes. For Company B, the situation may be the opposite: its reduction costs are € 15 (i.e. higher than the market price) so it will prefer to buy allowances instead of reducing emissions.

Company A spends € 50.000 on reducing 10,000 tonnes at a cost of € 5 per tonne and receives € 50,000 from selling 5.000 tonnes at a price of € 10. So Company A fully offsets its emission reduction costs by selling allowances, whereas without the Emissions Trading Scheme it would have had a net cost of € 25,000 to bear.

Company B spends € 50,000 on buying 5,000 tonnes at a price of € 10. In the absence of the flexibility provided by the Emissions Trading Scheme, company B would have had to spend € 75,000.

Since only a company that has low reduction costs and therefore has chosen to reduce its emissions, like Company A, is able to sell, the allowances that Company B buys represent a reduction of emissions, even if Company B did not itself reduce emissions.

Source: Questions & Answers on Emissions Trading and National Allocation Plans, MEMO/04/44, Brussels, 4 March 2004 (updated version as of 7 July).

Notes

13 European Environment Agency (EEA), *Greenhouse gas emissions trends and projections in Europe 2005*, No. 8/2005 (available at: <http://reports.eea.eu.int/eea_report_2005_8/en/GHG2005.pdf>).

14 EU ETS Directive, as note 4 above, at Recital 5.

15 Phase I: 95% of the EUAs must be free, Phase II: 90% of the EUAs must be free.

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An electronic registry system keeps track of the ownership of the allowances.[16] The European Commission ('EC') analogizes it to a banking system in which the allowances are currency and each operator falling under the EU ETS, and any party buying and/or selling allowances, has an account. The registry system is designed in a spokes and hub format. Each Member State has its own national registry that includes the accounts with allowances. The national authorities will deposit into operators' accounts the allowances that they have been allocated under the approved national allocation plan ('NAP').

By 30 April each year, after the actual emissions per operator have been verified, each operator must surrender the appropriate number of allowances for the preceding calendar year (i.e. by 30 April 2006, allowances must be surrendered for the 2005 year). If an installation emits more CO_2 than it surrenders, the operator of the installation will be fined[17] and must also obtain allowances to cover the installation's shortfall. The installation's name will be published, and national penalties may also apply.

During the first trading period from 2005-2007 ('Phase I') the EU ETS covers large emitters of CO_2, who are responsible for close to 45 per cent of the EU's total CO_2 emissions (approximately 30 per cent of total greenhouse gas emissions):[18]

- Combustion installations with a rated thermal input exceeding 20 MW (except hazardous or municipal waste installations);
- Mineral oil refineries;
- Coke ovens;
- Metal ore (including sulphide ore) roasting or sintering installations;
- Installations for the production of pig iron or steel (primary or secondary fusion) including continuous casting with a capacity exceeding 2.5 tonnes/hour;
- Installations for the production of cement clinker in rotary kilns with a production capacity exceeding 500 tonnes/day or lime in rotary kilns with a production capacity exceeding 50;
- Installations for the manufacturing of glass including glass fibre with a melting capacity exceeding 20 tonnes/day; and,
- Installations for the manufacture of ceramic products by firing (particularly roofing tiles, bricks, refractory bricks, tiles, stoneware or porcelain) with a production capacity exceeding 75 tonnes/day and/or a kiln capacity exceeding 4 m^3 with a setting density per kiln exceeding 300 kg/m^3.[19]

However, for the second trading period from 2008-2012 ('Phase II'), Member States may, under certain conditions, include additional activities not listed above and additional GHG, such as methane (CH_4), nitrous oxide (N_2O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs), and sulphur hexafluoride (SF_6).[20]

A. Member States' rights and obligations under the EU ETS

1. Drafting the National Allocation Plans

Each Member State drafts a NAP stating, among other things, the total quantity of allowances that it intends to allocate for the Phase and how it will allocate the allowances.[21] The provisional NAP must include a list of the installations covered by the EU ETS and the number of allowances each installation is to receive.[22]

All of the Member States' NAPs are evaluated under the same criteria.[23] Annex III of the EU ETS Directive includes the following criteria, which must be followed, although not all of them are mandatory:

1. Kyoto commitments;
2. Assessment of actual and projected emissions;
3. Potential (including the technological potential) to reduce emissions;
4. Consistency with other legislation;

Notes

16 Commission Regulation (EC) No. 2216/2004 of 21 December 2004 for a standardized and secured system of registries pursuant to Directive 2003/87/EC of the European Parliament and of the Council and Decision No. 280/2004/EC of the European Parliament and of the Council provides the procedural and technical aspects of establishing registries, [2004] OJ L386/1.

17 During Phase I the amount of the fine is 40 €; during Phase II, it is 100 €.

18 EU emissions trading: an open scheme promoting global innovation to combat climate change.

19 EU ETS Directive, as note 4 above, at Annex I. According to Article 24(1) of the Directive, Member States may include installations with lower capacities.

20 According to the EU ETS Directive Art. 24(1), Member States may include additional GHG provided that inclusion is approved by the European Commission, 'taking into account all relevant criteria, in particular effects on the internal market, potential distortions of competition, the environmental integrity of the scheme and reliability of the planned monitoring and reporting system.'

21 Article 9(1) of the EU ETS Directive, as note 4 above, at Article 9(1).

22 EU ETS Directive, as note 4 above, at criterion 10 of Annex III.

23 The criteria are provided in Article 10 and Annex III of the EU ETS Directive.

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5. Non-discrimination between companies and/or sectors;
6. New entrants;
7. Early action;
8. Clean technology;
9. Involvement of the public;
10. List of installations;
11. Competition from outside the Union; and,
12. Limit on JI and CDM compliance use by operators.[24]

As required by the EU ETS Directive, the EC did issue a communication providing Member States with guidance as they drafted their NAPs for the first time (the 'Phase I Guidance').[25] The guidance was the EC's interpretation of the NAPs criteria and the means by which the EC would evaluate each proposed NAP.

On 22 December 2005, the EC published further guidance for the 2008-2012 trading period (the 'Phase II Guidance').[26] Among the issues addressed are the need for less complex NAPs (including administrative procedures) and greater harmonization of allocation rules, such as the application of the same definition for 'combustion installation.' The EC also drafted tables which are intended to 'ensure a fully consistent assessment of all plans.'[27]

Such Guidance documents are not legally binding, although they put forth the EC's position and, thus, the EC is bound to evaluate the NAPs in the said manner. In order to impose obligations outside the scope of the Directive, the EC would have to legally change it.[28]

2. Submission of the NAP to the European Commission

The clock starts ticking when a Member State submits its provisional NAP to the EC. Within three months of submission the EC may reject the provisional NAP.[29]

The EC is assisted by the Climate Change Committee ('CCC')[30] which is comprised of a representative from each Member State.

The CCC meets rather infrequently;[31] and has, thus far, been consulted on a variety of issues including: the guidelines for the monitoring and reporting of greenhouse gas emissions; the system of registries; the temporary exclusion ('opt-out') of certain installations by the United Kingdom and the Netherlands; the unilateral inclusion ('opt-in') of additional activities by Sweden, Slovenia, Latvia, Finland and Austria,[32] and many other issues.[33]

The voting rule in the CCC is qualified majority, whereby each Member State receives a different amount

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24 Criterion 12 has been added by Directive 2004/101/EC of the European Parliament and of the Council of 27 October 2004 amending Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the Community, in respect of the Kyoto Protocol's project mechanisms, [2004] OJ L 338/18.

25 Pursuant to the EU ETS Directive, as note 4 above, at Article 9(1), the European Commission developed and published guidance on the implementation of the criteria listed in Annex III, *see Communication from the European Commission on guidance to assist Member States in the implementation of the criteria listed in Annex III to Directive 2003/87/EC*, COM (2003) 830 final, (hereinafter: the 'Phase I Guidance').

26 COM(2005)703 final.

27 Ibid., at Para. 6.

28 The ways by which the EC could legally change aspects of the EU ETS are not viable options, due in part to the fact that Phase II provisional NAPs are due by 30 June 2006. An amendment to the Directive must go through the co-decision procedure, which could take anywhere from 18 months to two years. Any amendments to the Annex III criteria, excluding criteria 1, 5, and 7 which may only be amended via co-decision, would go through the Comitology Committee procedure, which circumvents the European Parliament and is thus politically sensitive. (CEPS Task Force, *Reviewing the EU Emissions Trading Scheme Priorities for Short-Term Implementation of the Second Round of Allocation Part I Report of a CEPS Task Force*, Presented to UK Presidency in London, 7 July 2005, pp. 12-13.)

29 EU ETS Directive, as note 4 above, at Article 9(3): Within three months of notification, the EC may 'reject that plan' on that the basis that it is incompatible with the criteria provided in Annex III or Article 10 of the EU ETS Directive. If the plan is rejected, allocation decisions may not be taken until it amends its NAP in such a way that the EC approves.

30 The Climate Change Committee was created by Article 8 of Council Decision 93/389/EC of 24 June 1993 for a monitoring mechanism of Community CO2 and other greenhouse gas emissions, [1993] OJ L167/31. It adopted of its rules of procedure on 24 November 2003. It is called 'Climate Change Committee' since Decision 93/389/EC was replaced by Decision No. 280/2004/EC of the European Parliament and of the Council of 11 February 2004 concerning a mechanism for monitoring Community greenhouse gas emissions and for implementing the Kyoto Protocol, [2004] OJ L49/1.

31 The Committee met 2 times in 2002 (total 4 days); 3 times in 2003 (total 6 days) and 6 times in 2004 (total 10 days) (Reports from the Commission on the working of committees during 2002, 2003 and 2004). In 2005, the Committee met 4 times (Register of Comitology).

32 Climate Change Committee, 3rd Session Meeting agenda of 24–25 June 2004; Climate Change Committee, 4th Session Meeting agenda of 15 September 2004; Climate Change Committee, 5th Session Meeting agenda of 28–29 October 2004; Climate Change Committee, 6th Session Meeting agenda of 2 December 2004; Climate Change Committee, 8th Session Meeting agenda of 30 May 2005; Climate Change Committee, 9th Session Meeting agenda of 20 July 2005; Climate Change Committee, 10th Session Meeting agenda of 16 September 2005.

33 Such as: the rules implementing Decision 280/2004/EC; the questionnaire for reporting on the application of the ET Directive; the implementation rules for the linking Directive; data matching issues from national greenhouse gas inventories and Monitoring and Reporting under ETS; the Annual progress assessment by EEA; the EC National Communication to UNFCCC; the report from the EC GHG inventory in-country review; the report on activities in workgroups I, II and III

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of votes.[34] A *qualified majority* requires at least 232 votes in favour of the proposal. A blocking minority therefore consists of 90 votes. An additional requirement is that the 232 votes in favour must be cast by a majority of the members (i.e. 13).

The CCC is assisted by a Working Group, which is also comprised of a representative from each Member State, sometimes the same individual.

Member States encountered various hurdles during the first NAP evaluation process, irrespective of the Phase I Guidance:

> [O]nly very rarely does the concrete draft NAP, as presented originally by a Member State, fulfil all the criteria set under Annex III of the said Directive [...] [T]he procedure relating to the assessment of a proposed NAP involves a significant amount of negotiations with the Member State concerned with a view of finding a solution, which is satisfactory for both sides.[35]

The EC required cuts from 14 provisional NAPs. The number of allowances chopped off the Community's provisional total was more than 290 million. The EC found fault with provisional NAPs in other areas, including 13 instances of impermissible *ex-post* adjustments.[36] The EC maintained, and continues to maintain, the position that the EU ETS must function as a market, and as such, there must be consistency and predictability. Therefore, Member States were not permitted to include *ex-post* adjustment provisions since such activities would undermine the entire system and operators and other parties need to make their decisions in response to true market signals.

The NAP approval process for Phase I was indeed an intense 14 months for the EC. Without 25 approved NAPs, the legitimacy of the entire EU ETS was dangling. Greece was the last Member State to receive approval, which took place on 20 June 2005. Member States began submitting their NAPs in March 2004. The final result was the allocation of approximately 6.57 billion allowances to approximately 11,400 installations.[37]

3. Non-Compliance

If a Member State fails to fulfil an obligation, such as to transpose the EU ETS Directive and related legislation into national legislation, the EC may take the allegedly offending Member State before the European Court, after having given the Member State concerned two formal warnings.[38] If the Court's judgment provides that the Member State has failed to fulfil its obligations, the EC will issue a second reasoned opinion if the offending Member State fails to abide by the judgment. The EC may then bring the Member State before the Court again, requesting a monetary penalty.[39]

The following table gives an overview of the non-compliance procedures initiated against several Member States:

Alleged infringement	*Member State involved*
Failure to meet the 31 December 2003 deadline for transposing the ETS Directive into national law	All EU-15 Member States received a Letter of Formal Notice; Reasoned opinions were later sent to all EU-15 Member States except Austria, France, Germany and Sweden; four Member States (Belgium, Finland, Greece and Italy) were brought before Court of Justice
Failure to submit NAPs by 31 March 2004	Letters of Formal Notice were sent to Greece and Italy; A reasoned opinion was later addressed to Italy
Failure to link national registries with the EU-wide registry system by 31 December 2004	Letters of Formal Notice were sent to Cyprus, Greece, Luxembourg, Malta and Poland

Notes

34 France, Italy, Germany, and United Kingdom: 29; Poland, Spain: 27; the Netherlands: 13; Belgium, the Czech Republic, Greece, Hungary, Portugal: 12; Austria, Sweden: 10; Denmark, Finland, Ireland, Lithuania, Slovakia: 7; Cyprus, Estonia, Latvia, Luxembourg, Slovenia: 4; Malta: 3. The total amount of votes is 321.

35 Letter form the Secretary General of the Commission to Laura Atlee, 17 March 2005.

36 *Emissions trading: Commission approves last allocation plan ending NAP marathon*, IP/05/762.

37 Id.

38 It will first send a 'Letter of Formal Notice', usually giving the Member State two months to reply, and if the Member State fails to comply, it will send a 'Reasoned Opinion'.

39 Examples of fines levied on Member States in the area of environmental legislation include: Case C-294/03: Ireland was required to pay 21,600 €/day; Case C-41/01: Germany was required to pay 237,600 €/day; and Case C-387/97: Greece was required to pay 20,000 €/day. In particular, the EC considers 1) the seriousness of the infringement; 2) the duration of the infringement; and 3) the need to ensure that the penalty, itself, is a deterrent to continued and further infringement.

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Alleged infringement	*Member State involved*
Failure to submit information on greenhouse gas emissions for the year 2004	Letters of Formal Notice were sent to Cyprus, Italy, Malta and Spain
Failure to prepare by 15 January 2006 for international emissions trading under the Kyoto Protocol	Letters of Formal Notice were sent to Germany, Italy, Luxembourg and Spain
Failure to submit by 15 March 2005 information on policies and measures and on emission projections	Reasoned opinions were sent to Austria, Cyprus, Luxembourg, Malta and Poland

Source: European Commission (MEMO/04/44, IP/04/861, IP/05/35, IP/05/56, IP/05/72, IP/06/469) and Court of Justice of the European Communities

In the inverse, a Member State may also bring a case against an EU institution (or even another Member State). The Court of First Instance rendered a judgment on 23 November 2005 in a proceeding brought by the United Kingdom against the EC's refusal to accept a proposed amendment to its NAP. The proposed amendment would have increased the total number of allowances by 19.8 million tonnes of CO_2.[40] The EC rejected *any* amendments that had not been required by the EC during its evaluation of the UK's proposed NAP and, in particular, amendments increasing the total quantity of allowances. The Court did not rule on whether the amendment should be permitted; rather, it held that the EC 'could not restrict a Member State's right to propose amendments.'[41] Relying on the text of the EU ETS Directive and the EC's Phase I Guidance, the Court decided that such increases may well prove to be necessary. It emphasized that the purpose of the EU ETS is to establish a market for allowances with the least possible diminution of economic development and employment. Hence, irrespective of the question whether a proposed increase is compatible with the 12 criteria of Annex III to the EU ETS Directive, Member States are entitled to propose an increase of the total amount of allowances. Therefore, the Court annulled the EC's refusal decision.

The EC then issued a second Decision rejecting the proposal for an increase in the total number of allowances and concluded that the amendment was after the 30 September 2004 deadline and therefore impermissible. Rather than focusing on the merits of the proposal, the methodology and logic on which the proposed amendment was founded, the EC has escaped a complex and, possibly, political exchange with the United Kingdom's ministries by focusing on procedure.

Similarly, Germany has requested the Court to annul the EC's refusal to allow a provision for downwards *ex-post* adjustments.[42] This case is still pending.

B. Operators and Installations

Member States apply various methodologies to derive the quantity of allowances each installation should receive. Irrespective of the method applied, they must respect the EU's rules on State Aid. The EC reminds Member States of the ever-present State Aid rules in NAP criterion 5 on non-discrimination:

> The Plan shall not discriminate between companies or sectors in such a way as to unduly favour certain undertakings or activities in accordance with the requirements of the Treaty, in particular Articles 87 and 88 thereof.

A letter from the EC to Member States dated 17 March 2004 provides that State Aid is likely to be present in the following cases:

– a Member State allocates more allowances to undertakings than they need to cover their projected emissions during the relevant period ('over-allocation'), which would lead to a serious distortion of competition;

– a Member State underestimates emission reductions from the non-trading sector;

– a Member State grants allowances generously because it intends to buy emission allowance or make use of the flexible mechanisms (JI or CDM);

– a Member State allocates more allowances for free than it is required under the ETS (i.e. more than 95 per cent in Phase I or more than 90 per cent in Phase II); or,

Notes

40 Case T-178/05, *United Kingdom of Great Britain and Northern Ireland* v. *Commission of the European Communities.*
41 Ibid., at para. 61.
42 Case T-374/04, *Federal Republic of Germany* v. *Commission of the European Communities.*

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– a Member State issues allowances to replace allowances that have been cancelled, but not surrendered, in a previous trading period because they had not been used ('banking').[43]

If State Aid is involved, it is necessary – as a second step – to determine whether it is compatible with the Treaty Establishing the European Community.[44] Unfortunately, the *Community guidelines on State aid for environmental protection* do not provide a clear answer to this question.[45] Theoretically, the State Aid could be approved if it constitutes:

a) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest[46]; or,

b) aid to promote the execution of important projects of common European interest which are an environmental priority.[47] In such a case the aid must be necessary for the project to proceed, and the project must be specific, well defined and qualitatively important and must make an exemplary and clearly identifiable contribution to the common European interest.

Although the EC has screened all of the NAPs, it did not take any *formal* State Aid decisions. The EC concluded that, with the exception of Denmark[48], it could not rule out the possibility that the NAPs involved State Aid.

In particular, State Aid is an issue where:

1) a Member State allocates a total number of allowances which is inconsistent with projected emissions or it is inconsistent with the Member State's path to its Kyoto obligation (criteria 1 and 2 in Annex III to the EU ETS Directive) and the beneficiaries do not deliver a sufficient environmental counterpart; or,
2) a plan leads to discrimination between trading sectors or installations, e.g. by using unjustified different allocation methods for different sectors or applying an allocation method differently to certain undertakings; and
3) new entrants receive unjustified different treatment *vis-à-vis* incumbents.[49]

However, the EC decided that any State Aid was 'likely' to be compatible with the common market. Several Member States reduced the total number of allowances, abandoned reserves for specific sectors, or had justifiable reasons for maintaining different allocation methods for specific sectors.

As a procedural matter, the EC did not require 'formal' notification of any State Aid involved, as is normally the case under EC State Aid rules. Notification of the NAP was sufficient.

1. Appeals

Operators are concerned with the numbers of allowances they receive, other operators within their Member State receive, and their competitors receive. The EC is aware that certain industries are better equipped to pass on allowance expenses. In particular, the energy sector is believed to be most able to do so, particularly because it is not particularly vulnerable to global competition.

A number of operators have taken issue with not only their own allocations, but also, in some proceedings, with the greater EU ETS.

At the level of the EU courts, the following cases have been initiated:

- Case T-16/04:[50] Arcelor S.A against the EU ETS Directive;
- Case T-387/04:[51] EnBW Energie Baden-Wurttemberg AG against the EC's Decision for Germany;
- Case T-489/04:[52] US Steel Košice against the EC's Decision for the Slovak Republic.

HeidelbergCement ('HC'), a German cement producer, initiated several proceedings before regional courts. Both the Würzburg Administrative Court (Verwaltungsgericht or VG) and the Karlsruhe VG dismissed the enterprise's actions against the German Emissions Trading Act (Treibhausgas-Emissionshandelsgesetz). In a press release in 2004, HC commented that it was going to the Highest German Administrative Court

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43 Letter from the Director Generals of DG Environment and DG Competition to the Member States, entitled *State Aid and National Allocation Plans*, 17 March 2004, available at the website of the United Kingdom Ministry of the Environment, <www.defra.gov.uk>.
44 Treaty establishing the European Community, [2002] O.J. C325/1 (hereinafter: the 'EC Treaty').
45 [2001] OJ C37/3.
46 Article 87(3)(c) of the EC Treaty.
47 Ibid., at Article 87(3)(b).
48 Denmark had decided to auction the remaining 5% allowances, and had excluded 'banking.'
49 *Report from the Commission: Report on Competition Policy 2004*, SEC(2005) 805 final.
50 [2004] OJ C71/36.
51 [2004] OJ C6/38.
52 [2004] OJ C82/29.

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(Bundesverwaltungsgericht, which would lead to the German Federal Constitutional Court (Bundesverfassungsgericht).[53] In 2005, the Highest German Administrative Court ruled against HC, noting that the German Emissions Trading Act is legal.[54]

The Netherlands Council of State (Raad van State) faced submissions from 39 companies, which appealed the number of allowances they were allocated under the Dutch NAP. Ultimately, it found 17 of the appeals to be founded. The German emission trading authority, Deutsche Emissionshandelsstelle (DEHst), received approximately 810 appeals, with 80 of them being withdrawn. Therefore, it had 730 appeals to consider.

2. Emissions permits

Separate from the matter of allowances, in order to even emit GHG, an installation must be in possession of a permit from its competent authority. The permit ensures that the operator of the installation satisfies all monitoring and reporting requirements.[55] In order to participate in the scheme (e.g. buying and trading) it is unnecessary for an individual to obtain a permit. As part of the permit issuance procedure, the national authorities include the type of monitoring methodology the permit holder must apply. A permit holder's monitoring methodology is either specific to the installation or the national authority has 'general binding rules,' which must be applied.

3. Monitoring, reporting and verification

In order for the entire system to function, it must be supported by sound and transparent monitoring, reporting and verification schemes. In addition to provisions in the EU ETS Directive regulating these matters, the Commission Decision of 29 January 2004 provides legally binding guidelines for the monitoring and reporting of greenhouse gas emissions ('MRG').[56] There are numerous rules and procedures across Member States and within them. The majority of Member States include in each installation's permit a specific monitoring methodology. Irrespective, the applicable methodology must fulfil the elements put forth in the MRG.[57]

The monitoring system is divided into tiers, the higher the level, the greater the specificity and accuracy. The EC expects operators to apply the highest tier; however if an operator shows the national authorities that it is 'technically not feasible or would lead to unreasonably high costs,' the authorities may permit the operator to fulfil its obligations under a lower tier. An operator may apply a lower tiered monitoring methodology to a source that:

1) emits 2.5 kilotonnes or less per year; or,
2) contributes 5 per cent or less to an installation's annual emissions, ('whichever is the highest in terms of absolute emissions').

An operator may temporarily apply a lower tier if it is temporarily infeasible 'for technical reasons' for the operator to apply the monitoring methodology required by its permit *if* the operator proves that the temporary application of the lower-tier is necessary and it provides the national authorities with the details of the monitoring methodology it will be using during the time in question.[58] No tiered methodology is necessary for:

1) sources that emit 0.5 kilotonnes/year or less; or,
2) contribute less than 1 per cent to an installation's annual emissions ('whichever is the highest in terms of absolute emissions').[59]

If an operator does not comply with the monitoring methodology included in its permit, sanctions may be applied. The sanctions are imposed by the EU Member States and therefore may vary from Member State to Member State.[60] As would be expected, if an operator fails to submit its emissions report or it is late with its submission, a variety of sanctions, including prohibiting the installation from transferring allowances, may be imposed.

Operators' reports *must* go through a verification process. Annex V of the EU ETS Directive provides the

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53 *Würzburg Administrative Court dismissed appeal against TEHG*, 10 November 2004, available at: <http://www.heidelbergcement.com/html/e/page.asp?pageID=415>.

54 <http://www.123recht.net/article.asp?a=13645>; several companies also launched a proceeding before the Administrative Court in Berlin, against a reduction of the total amount of allocations.

55 Annex IV of the EU ETS Directive, as note 4 above, focuses on monitoring and reporting and Annex V of the EU ETS Directive addresses verification; *see* Commission Decision 2004/156/EC of 29 January 2004 establishing guidelines for the monitoring and reporting of greenhouse gas emissions pursuant to Directive 2003/87/EC of the European Parliament and of the Council, [2004] OJ L59/1 (hereinafter: the 'MRG').

56 Id.

57 Id. at Annex I, Section 4.2 of the MRG, *Answers to Frequently Asked Questions On Commission Decision 2004/156/EC* of 29 January 2004 establishing guidelines for the monitoring and reporting of greenhouse gas emissions pursuant to Directive 2003/87/EC (available at: <http://www.europa.eu.int/comm/environment/climat/emission/pdf/monitoring_report_faq.pdf>).

58 MRG, as note 55 above, at Annex I, Section 4.2.2.1.4.

59 Id.

60 EU ETS Directive, as note 4 above, at Art. 16(1).

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details, including the requirement that the 'reliability, credibility and accuracy of [the] monitoring systems and reported data and information relating to the emissions' are verified. A verifier must reject an installation's emissions report if he concludes that the report includes 'material' deviations.[61]

Operators are obligated to store raw data and supporting information for no less than 10 years.[62]

IV. Related Legislation

Without elaborating on the details of the Kyoto Protocol's flexible project-based instruments, the EU ETS does allow Clean Development Mechanism ('CDM') and Joint Implementation ('JI').[63] However, it is for each individual Member State to decide on the percentage permissible (if any) per installation, and the percentage must be included in the respective NAP. CDM projects produce 'certified emissions reductions' ('CERs'), which can be banked, carried over from Phase I to Phase II. JI projects produce 'emission reduction units' ('ERUs'). ERUs cannot be used in the EU ETS until Phase II. CDM allow an installation (or Member State) to carry out projects to reduce emissions in developing countries, whereas JI takes place in a country that has obligations under the Kyoto Protocol.

Prior to surrendering CER or ERU, the EUA, CER, and ERU are three separate trading currencies.

Box 2. Example of a CDM project.

A windpark generates 25.8 megawatts of electricity in China. The projected is predicted to yield approximately 578, 471 CERs from 2004-2013 by producing clean electricity rather than fossil-fuel based, CO2 emitting, electricity.

The revenue from the sale of [CERs] will help windpower projects to become more commercially viable, thus stimulating the market, increasing the volume of windpower developments in the country and in turn helping to reduce the cost of windpower due to the increased capacity of the industry.

Source: <http://www.senternovem.nl/carboncredits/projects/cer0133.asp>.

All types of JI and CDM credits may be used in the EU ETS except for credits generated via nuclear facilities (excluded by the Marrakesh Accords[64]) and sinks projects (they are difficult to integrate with the EU ETS).

V. Lessons to be learnt from Phase I

The EC must report to the European Parliament and the Council by 30 June 2006 on a number of issues, including how and whether additional GHG should be included in the EU ETS, the EU ETS's relationship with the international emissions trading that will start in 2008, and further harmonization of the method of allocation and the criteria of Annex III.[65]

Phase I NAP matters are not entirely behind the EC, due in part to the recent judgment issued by the European Court of First Instance in the case between the United Kingdom and the EC and the case Germany currently has pending before the Court of First Instance.

For all of the fanfare, out of the 2.2 billion allowances available for 2005, only slightly more than 260 million were traded.[66] The low number of trades could be attributed to any number of issues, including on-going technical and procedural complications, scepticism about the whole scheme, and/or operators waiting to see how many allowances they will likely need to surrender each year. Indeed, trading activities could heavily increase as the end of 2007 approaches and operators are at the end of their Phase I allowances.

Notes

61 *Answers to Frequently Asked Questions*, as note 57 above.
62 MRG, as note 55 above, at Annex I, Section 6.
63 EU ETS Directive, as note 4 above.
64 As noted in the Marrakesh Accords, Annex I Parties may not use ERU or CER generated by nuclear facilities to meet their commitments.
65 EU ETS Directive, as note 4 above, at Art. 30(2)(a). Other issues are: the use of credits from project mechanisms; the relationship of emissions trading with other policies and measures implemented at Member State and Community level, including taxation, that pursue the same objectives; whether it is appropriate for there to be a single Community registry; the level of excess emissions penalties, taking into account, *inter alia*, inflation; the functioning of the allowance market, covering in particular any possible market disturbances; how to adapt the Community scheme to an enlarged European Union; pooling; the practicality of developing Community-wide benchmarks as a basis for allocation, taking into account the best available techniques and cost-benefit analysis.
66 *The EU ETS Begins*, published on 4 January 2006, available at <http://www.europeanclimateexchange.com/index_flash.php>; Annex to the Communication from the Commission to the Council and the European Parliament 2005 Environment Policy Review, SEC(2006) 218.

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A stakeholders' survey was conducted from June until September 2005; NGOs, government bodies, and industries participated.[67] Government bodies and companies agree that long term uncertainty is a serious problem. However, governments are fine with 5-year allocation periods, while companies would prefer them to be 10 or more years long. Other points of interest in the document supposed by DG-Environment include the fact that a large majority of all respondents favours a harmonized approach to new entrants and free allocation:

- Nearly 75 per cent of all respondents favour free allocation to new entrants;[68]
- Companies and government bodies have divergent views on closure rules. The majority of companies and associations would like to keep allowances at closure, while government bodies would rather not allow this.[69]

Companies would like to have 2-3 years of advance notice on the number of allowances they will receive.[70] Additionally, companies would prefer to be able to transfer allowances to new assets across borders at closure.[71] The interaction between government bodies and companies during the preparation of the Phase I NAPs apparently left something to be desired. While companies, in part, do not find their feedback reflected, government bodies find feedback from companies difficult to incorporate in many instances.[72]

1. Tax and Accounting Treatment and Financial Services

The passing of the first year of the EU ETS, and thus the passing of a financial year for participants in the system, has bred a certain number of accounting questions. Unfortunately the questions have not been answered, and it is unlikely that a number of them will be for months, if not years, to come.

> '"People are doing the best they can with existing standards, which were not written for carbon trading", David Tweedie, chairman of the International Accounting Standards Board, told reporters. The IASB drew up the new accounting rules and is responsible for amending them. "We are still working on this. There are different views on this, with three to four of the standards affected." A key bone of contention is the representation of government grants in this sector. [...] [T]he IASB is not expected to introduce any new standards this year or probably next year either, Tweedie told the European Parliament's economic affairs committee. EU Internal Market Commissioner Charlie McCreevy has said the IFRS rules must have time to bed down before big changes.'[73]

Some assistance can be found with respect to 'derivative contract[s] relating to emissions allowances,' which are 'settled by amendment of the parties' positions on the applicable register of emissions allowances'. In this regard, if they meet certain conditions in the Commission Regulation implementing Directive 2004/39EC[74] they would be treated in the same fashion as:

> 'Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, *inter alia*, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.'[75]

The selling of emissions allowances on the secondary market is a supply of services, and thus falls under the auspice of the Sixth VAT Directive.[76] However, Member

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67 Review of EU Emissions Trading Scheme, available at: <http://www.europa.eu.int/comm/environment/climat/pdf/highlights_ets_en.pdf>.
68 Ibid., At p. 19.
69 Id.
70 Ibid., at p. 10.
71 Ibid., at p. 20.
72 Ibid., at p. 21.
73 *EU carbon reporting rule not ready for March*, Tuesday 31 January 2006 (Reuters).
74 *Background Note to the Commission Regulation implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purpose of that Directive*, p. 13 (available at: <http://europa.eu.int/comm/internal_market/securities/docs/isd/dir-2004-39-implement/reg-backgroundnote_en.pdf>).
75 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, [2004] OJ L145/1, Section C, para. 10.
76 Sixth VAT Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, [1977] OJ L145/1); Council Regulation (EC) No. 1777/2005 of 17 October 2005

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States and the EC have been taking various positions as to under which part of the Sixth VAT Directive the service falls.

Currently a number of entities are booking allowances as intangible assets.[77] Intangible assets are anything owned, whether in possession or by right to take possession, by an individual or group, and the value can be expressed in monetary terms. They are listed on the balance sheet, with a normal balance of debit. Contract-based intangible assets include such items as use rights, licensing and royalty agreements, franchise agreements, and service or supply contacts.

Depending on price developments, allowances may constitute a major factor in a company's profit and loss account. The International Financial Reporting Interpretations Committee attempted to provide guidance on the matter; however it discovered that if allowances were valued at cost and the company's liability was recorded at market value the two could not be reconciled. Thus, until this accounting puzzle can be pieced together, a company's emissions trading is determined by reporting rules, not performance.[78]

Some Member States question classifying allowances as intangible assets. They prefer to call them commodities or rights.

2. The Phase II Guidance

In theory, guidance explaining a complicated system is welcomed by participants. To this extent, the EC has issued Phase I and Phase II Guidances to assist with the NAP drafting. However, the innocent looking assistance, preaching transparency and simplicity, may reach beyond the legal limits of the EC and merely complicate certain matters. From the outset, the EC expects the Member States to include the tables provided in Annex 10 of the Phase II Guidance in their respective NAPs. The EC's motive is that the use of the tables will 'ensure a fully consistent assessment of all plans.'[79] A Member State is not required to use the tables provided as an annex. However, failing to do so may well prolong the approval process and may provide the EC and CCC with even more discretion when considering whether a NAP fulfils the necessary criteria.

The EC clearly states that it 'will not accept amendments to national allocation plans notified after the deadline of December 2006 [...] other than those required by the respective Commission decision on a [NAP].' This comment is in response to the drawn out process for Phase I; and it is likely in response to the recent case brought by the United Kingdom, which the EC chose not to appeal. However, it is unlikely that the EC can totally ignore a Member State's need to make *any* amendment and indeed this is an aspect of the Phase II Guidance with which the Dutch Authorities have taken issue.[80] If the EC does maintain its position, it will likely be taken back to the Court and face a judgment similar to the one issued in the United Kingdom proceeding.

The Phase II Guidance may stir a significant amount of controversy if the EC concludes that Member States that are fully meeting their Kyoto targets, and are satisfying the necessary NAP criteria, require further measures.[81] Indeed, the Phase II Guidance later states, '[S]ome Member States have to lower the first period caps to respect the Kyoto target. Other Member States need to maintain their first phase caps to align the plan with the potential to reduce emissions (criterion 3).'[82] A very realistic scenario may clash with the EC's position; how will the EC evaluate a proposed cap that is higher than the respective Member State's Phase I cap, but well within its Kyoto obligation? Several 'new' Member States are well below their Kyoto obligations and have economies in transition. Their industries, particularly industrial industries subject to the EU ETS, are growing.

It is acceptable for the EC to consider Member States' GDPs when evaluating submitted NAPs, and criterion 3 clearly states that the quantities of allowances 'shall be consistent with the *potential* of activities covered by [the scheme] to reduce emissions.' The EC gives some insight into the methodology it applies when evaluating NAPs under criterion 3 on the Phase II Guidance.[83] However, an absolute, formulaic approach, particularly if it is based on information extracted from sources other than those maintained by individual Member States, may be impermissible. In addition to being potentially overly broad, it may be discriminatory and fail to take into consideration each Member State's unique characteristics and needs.

In particular, if the EC pursued a policy of imposing new caps based on carbon intensity, as is suggested by the Phase II Guidance then this would be incompatible

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laying down implementing measures for Directive 77/388/EEC on the common system of value added tax (will come into effect in July 2006), [2005] OJ L288/1.

77 *See for example, Neste Oil Corporation Stock Exchange Release*, 5 August 2005 and *Egenhofer and Fujiwara*, available at: <www.kauppalehti.fi/4/i/eng/stocks/share/bulletin.jsp?id=200508043095&stoid=NES1V&comid=NES>; CEPS Task Force, as note 28 above, at p.14.

78 Id.

79 Phase II Guidance, as note 26 above, at para. 6.

80 Ibid., at para. 7.

81 Ibid., at para. 9.

82 Ibid., at para. 14.

83 *See* ibid., at Section 3.2.

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with the current legislation. The EC may attempt to calculate a new set of emission caps – below those set by the Kyoto protocol – and presumably enforce those caps through its power to veto NAPs as inconsistent with Annex III of the EU ETS Directive

The EC indicates that it will require substantiation of Member States' emissions reduction policies outside the EU ETS so as to ensure that the total emissions proposed in the provisional NAP is indeed consistent with the Member State's Kyoto commitments (criterion 1 of Annex III).[84] The EC sets out criteria for assessing these policies in Annex V of the Phase II Guidance and indicates that it will assess them 'in a stringent manner.'[85] If the EC is not satisfied, it would likely veto the NAP as inconsistent with criterion 1 of Annex III. Thus, the EC may be using the EU ETS Directive and related legislation to expand its competence outside the scope of what is directly applicable.

The EC 'considers it necessary that Member States do not rely on [Phase I] emissions or other [Phase I] data' when calculating installations' individual quantities.[86] In the subsequent paragraph the EC notes that by ignoring Phase I data early action is adequately recognized and 'substitutes' for means by which Member States accommodate early action. Criterion 7 allows Member States to accommodate early action, although it does not require them to do so. The EC's rather circular position means that all Member States that do not rely on Phase I data accommodate early action. Any number of questions may arise from this, including how the EC will treat NAP provisions that both ignore Phase I data and accommodate early action in another way. It is also unclear what will happen if a Member State does consider Phase I data; whereas it has the option not to accommodate early action.

Outside of the context of early action, it should be noted that the EC clearly states that if Phase I data is relied on that installations that:

> have actively reduced emissions in the first trading period are unduly disadvantaged by receiving in the second phase a smaller share of allowances than installations that have not reduced emissions during the first period.

This statement appears to suggest that Member States may grant installations more allowances than they actually need in Phase II if they have been particularly effective in reducing emissions in Phase I. It is difficult to reconcile this position with the State Aid rules of the EC Treaty or criterion 5 of Annex III to the EU ETS.

During the evaluation of the Phase I NAPs, the EC required certain modifications, including reductions to national allowance totals and the abandonment of sector-specific reserves.[87] Within certain NAPs, Member States used different allocation methodologies for different sectors; in the majority of instances the EC did not take issue with the justifications for various methodologies.[88] Considering the fact that the EU ETS is worth billions of euros,[89] it is surprising that all of the NAPs were only evaluated within the context of the EU ETS Directive, rather than the EC taking formal State Aid decisions on the proposed NAPs.[90]

The EC notes that the ideal solution would be for all parties to pay for their allowances irrespective if they are required to participate in the EU ETS. Then, State Aid would not be an issue. This, however, is highly unlikely to happen in the near future.

The Dutch Authorities have taken issue with the EC's interpretation of waste incineration. In particular, they believe that it should have a broader interpretation than that in Annex 8 of the Phase II Guidance, which defines combustion installation. However the Phase II Guidance very clearly states that Annex 8 contains 'the Commission's interpretation of combustion installation'. Thus, the Dutch authorities' Phase II provisional NAP will be interpreted in light of the EC's definition of a combustion installation. The conflicting views generate a legal conundrum. The EC adheres to the position it puts forth in the Phase II Guidance; the Phase II Guidance is not legally binding on Member States. In a hypothetical situation, the Dutch authorities include the interpretation they believe appropriate; the EC rejects the provisional NAP. Would the Dutch authorities modify their provisional NAP, or would they take the EC before the Court?

The EC 'recommends Member States ensure in particular that the new entrants reserve not be replenished upon exhaustion, that allowances not allocated to closed installations be cancelled or auctioned, and that

Notes

84 Ibid., at para. 20.
85 Ibid., at para. 19.
86 Ibid., at para. 27.
87 Commission of the European Communities, *Report on Competition Policy vol. 1* (Published in conjunction with the *General Report on the Activities of the European Union — 2004*), 2004. SEC(2005) 805 final, para. 523.
88 Id.
89 The European Climate Exchange noted at the end of 2005, 'Going forward, if the EU carbon market were to trade three times its underlying asset value, current prices would make it worth close to €150 billion'; *ECX Review, 2005: The EU ETS Begins*, published on 4 January 2006, available at <http://www.europeanclimateexchange.com/index_flash.php>.
90 Commission of the European Communities, as note 87 above, at para. 524.

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there be no allocation at projected needs to new installations.'[91] It goes on to state that these matters will be more appropriately dealt with in the June 2006 review. It is not evident whether the EC's 'recommendation' is truly a recommendation or if a Member State would be required to amend its NAP if the plan included one of the above possibilities. If all laws and principles, including legislation on State Aid, are observed, it is unclear why a Member State cannot put a closed installation's provisional allowances into a new entrant reserve rather than cancel or auction them.

3. Energy[92]

The issue of local versus global competition is particularly prevalent in conversations about the distribution and price increases of allowances. Industries on the global market, such as steel, ceramics, and glass, must battle competitors in any number of regions, including India, China, and the United States. When a new market opens, any financial edge a producer can have over other producers in the industry can mean the difference between bankruptcy and comfortable profits. Fully passing on the price of allowances to consumers simply is not an option. Arguably, the industry that faces the least global competition and is best able to pass through the necessary costs, the energy sector, is facing the brunt of the EU ETS Directive and in a strange departure from the norm, the energy sector is relatively pleased by it. The energy sector may receive a certain number of allowances for free from respective Member States; however, this has not prevented it from tacking allowance costs onto fees. That said: it is unclear how much of the recent energy price increases can be attributed to the EU ETS.

Table 1. Electricity Price Summary 1997-2005 for EU 15[93]

1997-100, constant prices	*July 1997*	*July 2000*	*July 2005*
Average (all consumers)	100	86	90
Very large: consumption of up to 450GWh/year (maximum load 50MW). Only data for BE, DE, FR, GR, IT, NL, PT, ES, UK included	100	83	96
Medium industrial: Average of 24GWh/year and 2GWh/year consumer types	100	82	95
Small commercial and household: Average of 50MWh/year, 7.5MWh/year and 3.5MWh/year consumer types	100	88	88

Large electricity users are of the opinion that the EU ETS has 'exacerbated the trend in higher prices' and that electricity installations that have received allowances under their respective NAPs 'have received unearned windfall profit.'[94] They maintain that the price has been passed directly into the wholesale price.[95] The opinion is well substantiated; regulators have seen drastic wholesale price increases in the electricity market and 'unexpectedly high prices' for allowances 'have been quickly built into forward prices.'[96]

Notes

91 Phase II Guidance, as note 26 above, at Annex 7, para. 3.
92 Commission of the European Communities, Technical Annex to the *Report from the Commission to the Council and the European Parliament on Progress in Creating the Internal Gas and Electricity Market*. SEC(2005) 1448, pp.20-21.
93 Ibid., at p. 19.
94 Ibid., at p. 13.
95 Ibid., at p. 52.
96 Ibid., at p. 51.

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Table 2. Gas Price Summary 1997-2005 for EU 15[97]

1997-100, constant prices	*July 1997*	*July 2000*	*July 2005*
Average (all consumers)	100	92	122
Very large industrial users: Consumption of around 100mcm/year	100	98	135
Large industrial users: Consumption around 10mcm/year	100	93	137
Medium industrial: Consumption 1 mcm/year	100	95	140
Small commercial and household: Average of 10,000m^3, 2,000m^3 and 400m^3 consumer types	100	91	115

Oil prices have risen significantly since 2000, and while it is a controversial linkage, some relationship likely exists between oil and gas prices, whereas it has in the past. In response to a question put forth by a Member of the European Parliament, the EC stated:

> 'Gas prices have traditionally been indexed to oil prices because gas can be substituted for oil, and to allow natural gas to penetrate in oil dominated market segments. In the absence of gas-to-gas competition, gas prices in Europe therefore closely follow oil price developments on the world market, albeit with a couple months delay. This fuel price inter-relationship affects the consumer through the tariffs applied for gas consumption.'[98]

With the recent developments in the oil industry, it is difficult to attribute certain costs to the initiation of the EU ETS and other costs to oil increases. Crude oil spot prices have more than doubled when comparing 1994 with 2004 (228 per cent for Dubai, 242 per cent for Brent, 234 per cent for Nigerian Forcados, and 241 per cent for West Texas Intermediate).[99]

Public sector unions believe that both the gas sector and electricity sector have obtained additional profits from the allowances issued by the respective national authorities.[100] Member States, such as Finland, are attempting to counteract this issue of windfall profits; they would like to see at least some of the profits passed onto consumers.[101]

4. Verification

The EU ETS requires verification of data. The MRG allegedly provides the necessary explanatory notes; however, this document cannot remedy the fundamental problems with the verification requirement, including the fact that no EU-wide verification accreditation body exists. Indeed, it was necessary for a working group comprised of representatives from European Accreditation Bodies, competent authorities, operators and verifiers from the International Emissions Trading Association and Member States' authorities who oversee EU ETS related matters in their respective governments, to draft guidance for the assessment of verification bodies who are seeking accreditation as competent bodies to verify GHG emission reports and data.[102] As noted by the EC, a 'verifier should therefore comply with the national accreditation requirements, subject to the requirement not to restrict the free movement of services pursuant to Article 49 to 55 of the EC Treaty.'[103] Different Member States may have different accreditation requirements, or very general guidelines.

The working group's guidance includes a long list of requirements, both educational and practical, in order for an individual to be deemed competent to perform verifications. It does note that for the initial period there will not be enough GHG auditors and/or GHG lead auditors who satisfy the requirements. Therefore, during this time of transition, individuals with experience with 'Environment Management System (EMS) certification

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97 Ibid., at p. 19.
98 Written Question E-3287/00 by Bart Staes (Verts/ALE) to the Commission (25 October 2000) and Answer given by Mrs. De Palacio on behalf of the Commission (29 November 2000).
99 Available at: <http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/publications/energy_reviews_2005/STAGING/local_assets/downloads/spreadsheets/statistical_review_full_report_workbook_2005.xls>.
100 Commission of the European Communities, as note 92 above, at p. 15.
101 *Finland to deal with windfall profits*, 8 February 2006, available at: <www.pointcarbon.com>.
102 European Co-operation for Accreditation (EA) Certification Committee, *Guidance for Recognition of Verification Bodies under EU ETS Directive, Final Draft for Approval*, 18 January 2005.
103 *Answers to Frequently Asked Questions*, as note 57 above.

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auditing, Eco-management and audit scheme (EMAS) validation, or other types of verification and validation of environmental statements' may be acceptable.[104] Arguably, installations' verification reports are crucial to the functioning of the EU ETS. The number of disposable allowances depends on how many allowances must be surrendered each year. The number of allowances surrendered must match the tonnes of carbon dioxide emitted. This rather practical matter can skew the market unnecessarily if not remedied; it could be as simple as requiring all Member States to apply the same accreditation requirements, or having European institutions train verifiers.

5. Closure

In the introduction to the Phase II Guidance, among other goals, the EC encourages Member States to simplify their rules on closures.[105] However, the section specifically addressing closures fails to provide any additional assistance. In a slightly self-congratulatory manner, the EC notes that it did not take issue with Member States' closure provisions, as long as the provisions were not disguised *ex-post* adjustments. Dodging the topic, the EC goes on to say, '[T]he Commission considers it premature to draw conclusions and identify best practice.' The only advice is that unallocated allowances, due to closures, are either cancelled or auctioned. The EC claims that the June 2006 EU ETS Review Report will consider 'EU-wide administrative rules on closure'.

Phase II provisional NAPs are due at the same time that the EC will be issuing its Review Report; thus, they are left to their own devices. The issue of closures goes beyond operators shutting their doors and their businesses. It trickles into matters of property and bankruptcy. Allowance allocations for partial and temporary closures are not adjusted downward, whereas the EC found such adjustments to be impermissible *ex-post* adjustments.[106] In the case of permanent closure, some Member States, such as the United Kingdom, permit the installation to retain the allowances for the year of closure; however, any subsequent allocations are withheld. But what if the operator sells the business? Do the allowances stay with the installation and the new operator, or may the previous operator retain them? Member States' NAPs include the quantities of allowances to be allocated to each *installation*[107] and when there is a change in an installation's operator, the national authorities must 'update' the installation's permit.[108] However, the allowances are allocated to the operator of each installation.[109]

Could the new operator apply as a new entrant? If such is the case, the new operator might receive allowances from a new entrant reserve or have to buy them on the market. And what becomes of the allowances retained by the previous operator; is the operator free to sell the allowances? Additional questions arise when a closure is due to insolvency. In such a case, *if* the operator, i.e. the business entity, retains the allowances for the last year during which the installation operated, who may lay claim to the unused allowances? May creditors receive the allowances? If the installation does not have enough allowances to surrender to match its emissions, will it be penalized, and how? The EU ETS is in its infant stage, but as the price of allowances increases, so does the urgency for answers.

6. Registry

The EC constantly reminds Member States that *ex-post* adjustments are impermissible. Indeed, the DG Environment website states, in the section concerning NAPS, '*Ex-post* adjustments are incompatible with the legal framework and represent interventions that disrupt the market and create uncertainty for companies.' However, the *ex-post* adjustment prohibition begins to fade when it is time for Member States to connect their national registries to the Community International Transaction Log ('CITL'). The Regulation[110] on Registries, a rather daunting piece of legislation adopted less than two weeks before the start of Phase I, may provide the EC with more leverage than its drafters intended.

Once a Member State has an EC approved NAP, it must construct a national registry that will be connected to the CITL. However, as part of the process the Member State must provide the EC with its NAP table, which includes the numbers of allowances to be allocated to certain accounts. According to the Regulation on Registries, the time between the approval of the final

Notes

104 European Co-operation for Accreditation (EA) Certification Committee, as note 102 above, at paras. 6.2.5.1 ad 6.2.5.2.

105 Phase II Guidance, as note 26 above, at para 5.

106 United Kingdom, *New Entry and Closure Decisions document May 2005*, available at: <http://www.dti.gov.uk/energy/sepn/new_decisions_new_entrants.pdf>; *see also Final Appendix C to the UK National Allocation Plan (NAP)*, published 24 May 2005, available at: <http://www.dti.gov.uk/energy/sepn/final_annex_c.pdf>.

107 EU ETS Directive, as note 4 above, at criterion 10 of Annex III.

108 Ibid., at Article 7.

109 Ibid., at Article 11.

110 Commission Regulation 2216/2004 of 21 December 2004 for a standardised and secured system of registries pursuant to Directive 2003/87/EC of the European Parliament and of the Council and Decision No. 280/2004/EC of the European Parliament and of the Council, [2004] OJ L386/1 (hereinafter: the 'Regulation on Registries').

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NAP and the completion of the national registry creates five possible scenarios:

1. No changes have been made to the NAP table;[111]
2. The table has been amended, and the amendments were previously approved by the EC;[112]
3. The table has been amended and the amendments are 'in accordance with [the] methodologies set out in' the NAP;[113]
4. The table has been amended and the amendments are 'the results of improvements in data';[114] or
5. The table has been amended for any other reason(s).[115]

If the last scenario exists, the EC may reject the amendment as incompatible with the NAP requirements under the EU ETS Directive, and refuse to instruct the CITL's administrator to connect the Member State's national registry. If the registry is not connected, operators cannot participate in over-the-counter trading.

The United Kingdom's case has shown that the EC is not inclined to issue new Decisions allowing Member States to modify their NAPs. Additionally, the EC may be blurring the varying scenarios. The EC may require an 'almost *ex-post'* adjustment by a Member State. If a Member State makes an amendment that falls under one of the first four scenarios or the EC insists that the Member State make an amendment, the EC may simply not instruct the CITL administrator to connect the national registry until its demands are met by the Member State. The Regulation's text may not explicitly allow such behaviour; however, the EC could delay issuing the necessary instructions.

VI. Conclusion

The purpose of this article has been to provide an overview of the ETS and to highlight certain issues that could be improved or that merit further attention. For one thing, transparency and predictability for businesses could certainly be improved. Although the companies affected are consulted during the phase of the drafting of the national plans, the actual approvals of the NAP by the EC and any negotiations with the Member States occur largely behind closed doors. The first phase of the ETS was also plagued by several missed deadlines, with the last NAP being officially approved well beyond the agreed date.

As with any project of such scale, the devil lies in the details. The ETS has many ramifications that can potentially create imbalances in the single market: this goes from the accreditation of verifiers to the issue of closures and the tax and accounting treatment of emission rights. It seems that the approach has been to have an imperfect system rather than to have no system at all.

There is no reason to believe that these remaining issues will not be addressed in the future. However, whether the ETS will achieve its real purpose, a reduction of carbon emissions, still remains to be seen.

Notes

111 Ibid., at Article 38(1).
112 Ibid., at Article 38(2).
113 Id.
114 Id.
115 Id.

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