1. The Emission Trading Scheme

The Emission Trading Scheme (ETS) (1) plays a major role in the Commission's Climate Change Policy. It aims at helping EU Member States to achieve compliance with their commitments under the Kyoto Protocol by using a market based instrument which allows achieving emission reductions at least cost.

The ETS is the first international trading system for CO₂ emissions in the world. It started on 1 January 2005 and, once all National Allocation Plans are implemented, will cover a total of more than 12000 installations in the EU-25 (combustion plants, oil refineries, coke ovens, iron and steel plants, and factories making cement, glass, lime, brick, ceramics, pulp and paper) representing close to half of Europe's emissions of CO₂.

Within certain limits, Member States define the amount of emission allowances they will distribute to participants. By handing out fewer allowances than companies are expected to need for covering their actual emissions, Member States create scarcity, which is the prerogative for the creation of a functioning market of emission allowances. Apart from the initial allocation, Member States are not supposed to intervene in the development of the market, and have in particular no further influence on the development of the price for emission allowances.

A cornerstone of the implementation of the ETS are the so-called National Allocation Plans (NAPs). These plans establish the total number of emission allowances Member States plan to allocate for the 2005-2007 trading period and the methods of allocating them to the different installations in the economic activities involved.

Member States were obliged to submit their NAPs by end of March 2004 (by 1 May 2004 for the new Member States) in view of the start of the new system on 1 January 2005. However, most of the Member States were late in submitting their plans.

The Emission Trading Directive requires the Commission to assess compliance of these plans with Article 10 of the ETS directive and with eleven criteria established in Annex III thereof. The Commission may refuse a plan in total or in part within three months from its notification if the plan is found incompliant. By the mid of February 2005, the Commission had taken decisions on 21 NAPs (2). The assessment of the plans of the Czech Republic, Poland, Greece and Italy is underway.

2. The assessment of the National Allocation Plans

The NAPS submitted to the Commission are far from uniform. Member States have opted for different approaches with regard to central elements of the allocations. Plans differ e.g. as regards the basis for initial allocations, rewards for early action, the consideration of technological emission reduction potential, the allocation to new entrants, and even to some extent with regard to the scope of installations covered by the scheme.

In January 2004 the Commission published guidance on the implementation of the allocation criteria, in order to ensure consistency and transparency. It grouped several plans for decisions at the same time, while assessing each plan on its own merits and it joined a communication to the Council and the European Parliament to each round of decisions, explaining the assessment of the plans and reasons for rejection.

---


(2) On 7 July the Commission decided on the NAPs of Denmark, Ireland, the Netherlands, Slovenia and Sweden; on 20 October decisions were taken on the NAPs of Belgium, Estonia, Latvia, Luxembourg, the Slovak Republic and Portugal; in late December decisions were taken on the NAPs of Cyprus, Hungary, Lithuania, Malta and Spain. The decisions are accessible at http://www.europa.eu.int/comm/environment/climat/emission_plans.htm.
Until now, the Commission required changes to plans mainly in three areas (1).

- If the allocation chosen by a Member State for the 2005-2007 trading period was not consistent with the Member States obligation to achieve its Kyoto target. This was the case in particular where a Member State could not sufficiently substantiate its intended use of flexible mechanisms and could therefore not demonstrate that with the use of these mechanisms it would be able to respect its target.

- If the volume of allowances for the 2005-2007 trading period was inconsistent with assessment of progress towards the Kyoto target, i.e. the allocation exceeds projected emissions.

- If a Member State intended to intervene in the market after the initial allocation by redistributing the issued allowances among the participating companies during the 2005-2007 trading period. This State intervention would alter the correct functioning of the market and create uncertainty for business.

3. Involvement of DG Competition in the assessment of the NAPs

Criterion 5 of Annex III of the ETS directive requires that a National Allocation 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’.

In its guidance document, the Commission confirmed that ‘the normal state aid rules will apply.’

By letter of 17 March 2004 to the Member States, the two director generals of DG Environment and DG Competition described under what circumstances state aid may be involved in National Allocation Plans and what they considered as potentially most distortive practices in the context of allowance allocation, potentially leading to incompatible state aid. The letter indicated that the assessment of the National Allocation Plans would primarily aim to ensure the environmental effectiveness of the overall scheme and to prevent significant distortions of competition, which could arise in particular in case of over-allocation of allowances.

The letter clarified that the Commission would not request automatically state aid notification of all NAPs. However the Commission would assess state aid aspects of the plans in the context of the assessment of NAPs under the emission trading directive. Where a NAP seemed to contain aid and where such aid was likely to be incompatible, the Commission would take action under the state aid rules.

When examining the National Allocation Plans, the Commission took account in particular of experience it had in assessing national emission trading systems put already in force by some Member States before the Emission Trading Directive.

The Commission considered that the allocation of emission allowances confers a selective advantage to certain undertakings which has the potential to distort competition and affect intra Community trade unless the allowances were sold to the recipients at the market price (2). As regards the use of state resources and their imputability to Member States, the specificities of the emission trading directive led to a differentiated assessment. Article 10 of the directive obliges Member States for the first trading period from 2005 until 2007 to allocate at least 95% of the allowances free of charge. This allows Member States to sell up to a maximum of 5% of the allowances. So far, Member States have made little use of this possibility. Only Denmark has decided to auction 5% of the allowances. Some other Member States envisage auctioning of unused allowances from the new entrants reserve at the end of the trading period or to auction a very limited number of allowances to cover the administrative costs of the implementation of the scheme. To the extent that a Member State does not use its possibility to sell allowances at a market price, the measure appears to be imputable to the Member States and to entail the use of State resources.

The measure may also contain state resources and be imputable to the Member State where a

(1) Where a plan has been approved by the Commission, the Member State can proceed to take a final allocation decision at national level. Before doing so, it can make changes o the number of allowances for individual plants as a result of improved data. A Member State may, however, not increase the total number of allowances it intends to put into circulation. Where a part of a plan was rejected and the Member States implements the proposed changes, it will not have to submit its plan to the Commission a second time but can proceed with the allocation decision at national level.

Member State allows banking of allowances from the first to the second trading period. Until now, all Member States with the exception of France excluded banking.

With the exception of Denmark, the Commission therefore could not exclude that the NAPs implied State aid pursuant to Article 87(1) of the Treaty.

The Commission assessed further if any potential aid was consistent with and seemed to be necessary to achieve the overall environmental objective of the ETS directive.

The Commission sought contacts with Member States in particular where a NAP seemed to contain one of the following features.

- Any potential aid does not contribute to achieve the environmental objective of the measure (this appears to be the case where a Member State allocates a total number of allowances which is not consistent with projected emissions or where it is inconsistent with its path to Kyoto)

- beneficiaries do not deliver a sufficient environmental counterpart for any potential aid (this will be the case where they receive more than realistically projected emissions, as the aid would then not have an incentive effect to change behaviour)

- 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; also with regard to unjustified different treatment of new entrants vis-à-vis incumbents.

When assessing the NAPs, the Commission encountered a limited number of such situations. Until now, most of potential threats to undistorted competition could be resolved in discussion with the Member State concerned. In several cases, Member States reduced the total number of allowances in order to comply with Criterion 1, 2 and 5 of the ETS directive. In some cases, Member States abandoned reserves established for specific sectors. The Commission therefore concluded for most NAPs that based on the information provided by the Member States, it considered that any potential aid was likely to be compatible with the common market should it be assessed in accordance with Article 88(3) of the Treaty.

It should be noted that the Commission until now screened all NAPs in the context of ETS directive in order to identify obvious problems of probably incompatible State aid. Until now, the Commission did not take any formal State aid decision on a National Allocation Plan. This does not give the Member State formal state aid approval of their NAP, but it indicates however that the Commission did not find obvious fault with the plan. This prima facie positive assessment can play a role in particular where complaints might be launched against a National Allocation Plan. Unless new evidence is brought forward, which casts doubts on the preliminary assessment, there is no reason why the Commission should come to a less positive assessment in case it would deal with a NAP in a state aid procedure.

In case any of the remaining four plans would contain features likely to create significant distortions of competition and the Member State concerned was not modifying its plan of its own accord, the Commission might need to request notification under Article 88(3) of the Treaty or to deal ex officio with a potentially illegal aid, had the aid already been granted. Considering the duration of a State aid investigation, in particular when a formal investigation procedure under Article 88(2) of the Treaty would need to be opened, this could considerably hamper this country's companies participation in the emerging carbon market.

4. Experience gained from the process

The implementation of the emission trading directive followed an extremely demanding schedule, not least due to the late submission of most of the National Allocation Plans. While it was critical that Commission and Member States set up the major elements of the emission trading construction in a credible and workable manner, this phase also needs to be seen as a learning phase. One should not forget that the carbon market is an emerging market. At this stage it was most important to ensure a certain scarcity of allowances and to secure against major distortions of competition. In this setting, the screening of the NAPs under state aid aspects preferably without entering into formal state aid investigations proved valuable. However, experience gained during the first trading period may well bring to light the need for a refinement of the application of the available instruments or even of the instruments themselves.