



EUROPEAN COMMISSION

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Subject: **N47/2006 - United Kingdom**
 Dispersed oil in produced water trading scheme

Madam,

1. Procedure

By letter dated 24 January 2006, registered on 25 January 2006, pursuant to article 88(3) of the EC Treaty, the UK authorities notified the Commission of their intention to introduce a trading scheme for dispersed oil in produced water that may be discharged from offshore installations into the sea. On 24 February 2006, the Commission requested further information on the measure, which was provided by the UK authorities by letter dated 27 March 2006, registered on the same day. A second letter requesting further information was sent by the Commission to the UK authorities on 24 April 2006. The requested information was provided by the UK authorities by letter dated 7 June 2006, registered on the same day.

2. Description of the measure

2.1 Objective of the scheme

The Convention for the Protection of the Marine Environment of the North East Atlantic (OSPAR) requires parties to the Convention to take action to prevent and eliminate pollution in the maritime area and conserve marine eco-systems. Article 5 and Annex III are particularly concerned with pollution from offshore sources. OSPAR Recommendation 2001/1 for the Management of Produced Water from Offshore Installations requires contracting parties to “*ensure that the total quantity of oil in produced water discharged into the sea in the year 2006 from all offshore installations under its jurisdiction has been reduced by a minimum of 15% compared to the equivalent discharge in the year 2000*”. Produced water is the water extracted from the subsurface with oil and gas. It may also include water from the reservoir or water injected into the formation during the drilling process.

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The UK baseline (year 2000) for discharges of dispersed oil in produced water is 5,749.36 tonnes. The agreed UK target (5,749.36 tonnes minus 15%) is 4,886.96 tonnes / year. Taking into account new discharging installations since 2000 and the usual (around 3%) yearly increase in produced water discharges, this target actually represents a 17.7% reduction. In order to make sure that this target is achieved and maintained in the years following 2006, the UK authorities decided to establish a discharge allowance trading scheme. Such trading scheme has been identified by the national authorities as the most cost-effective and equitable solution to achieve the desired environmental objective.

The OSPAR Offshore Industry Committee will review the targets in 2008, this review will however only affect the period after 2009. According to the notification, the UK is the only OSPAR contracting party that intends to maintain the 2006 target until the new OSPAR target period, against the otherwise rapidly increasing levels of produced water discharges.

2.2 Duration of the scheme

The dispersed oil in produced water trading scheme would enter into force on 1 January 2007. The first phase of the trading, for which the allocated discharge quantities are defined in the first allocation plan, would cover a period of three years until 31 December 2009. In their letter dated 7 June 2006, the UK authorities undertook to seek approval from the Commission prior to each new allocation plan.

2.3 Legal basis

The Offshore Petroleum Activities (Oil Pollution Prevention and Control) Regulations 2005 authorize the Secretary of State to establish emission trading schemes in relation to specified emissions, operating on the basis of allocation plans. The Secretary of State may also make provisions for penalties in respect of contraventions of the terms and conditions of the concerned trading scheme.

The notified allocation plan had previously been subject to public consultation with industry. The final version was submitted to the Commission by letter dated 7 June 2006.

There is no Community legislation to date transposing the OSPAR Recommendation 2001/1 into Community law. The environmental target established by the allocation plan is therefore based on the OSPAR Recommendation.

2.4 Beneficiaries

All offshore installations that are subject to a permit to discharge dispersed oil in produced water, are included in the trading scheme. Under the Offshore Petroleum Activities Regulations 2005, with the limited exceptions listed in article 3 of the Regulations, no oil can be discharged to the sea without a permit.

2.5 Aid mechanism

The basic idea of the proposed trading scheme is that the authorities allocate tradable allowances to discharge dispersed oil to the companies concerned and these companies are not allowed to discharge dispersed oil unless they have a corresponding allowance obtained either from the original allocation or by buying it on the market.

The total level of allocation is the OSPAR target of 4,886.96 tonnes of dispersed oil in produced water per year.

The allocation of allowances to each individual installation is determined on the basis of the installation's historical discharge in the year 2000, the so-called 'baseline'. This baseline is reduced by the above mentioned 17.7%. The allocation is the same for each of the three years covered by the first trading period. They receive the allowances at the beginning of each calendar year.

All allowances are distributed for free. The UK government is considering whether a percentage of the allowances could be auctioned for the trading periods following Phase I.

As a result of this system, companies that discharge less than their allowances, can sell the difference on the market to installations that discharge more than the allowances they have.

Allowances will be restricted to each relevant trading year. The banking of allowances from the current period to the next period will not be permitted.

Failure to surrender allowances equivalent to discharges will attract civil penalty. The level of the penalty will be assessed on the basis of the deficit between the surrendered allowances and the reported discharges. The precise level of the penalty will be approximately the double of the marginal cost of abatement.

The UK government declared that any funds arising from civil penalties for non-compliance would return directly to the central budget of the State. If the funds are used to finance a State aid scheme the UK authorities will respect their responsibilities under the Treaty to notify aid to the Commission for prior approval.

2.6 Other relevant rules of the allocation plan

The baseline for the calculation of the quantity of allowances is set on the basis of discharges in year 2000, as the OSPAR Recommendation identifies the year 2000 as the baseline for future reductions (see point 2.1 above).

In case of production increase between 2000 and 2006:

- if the production increase relates to the improved performance of existing wells or the drilling of additional wells at existing facilities, this increased production will not be taken into account in the installation baselines and allowances;
- for installations where new fields or drilling centers had been developed and where those tie-backs were projected to contribute greater than 33% of the total discharges in 2006, the baseline quantity has been increased by 33%. Where the new developments contribute greater than 66% of the 2006 discharges, the baseline quantity has been increased by 66%;
- where new stand-alone installations started production after 2000, the baseline is the quantity of discharge in the first complete calendar year of production. Where the installation had had a significant interruption in production during the baseline year, the baseline year was changed to the next complete calendar year of production.

In case of new drilling centers and tie-backs after the beginning of the trading, the operator will have to apply for allowances from the new entrant reserve (see below).

In case of production decrease between 2000 and 2006:

- the installation baselines and allowances will not be adjusted to take account of decreased production if this relates to the deteriorating performance or shut-in of existing wells.
- where tied-back drilling centers or fields have been closed or decommissioned (partial closure or decommissioning), the baselines have not been adjusted;
- where stand-alone installations have been decommissioned, their discharges have not been included in the aggregated baseline.

In case of closure or decommissioning after the beginning of the trading, the allocations for the next calendar year will be adjusted/withdrawn.

It must be noted that, under the OSPAR Recommendation 2001/1, decommissioning and cutting back production are recognized as acceptable means of achieving the reduction targets.

The below table shows the reduction targets over Phase I of the trading scheme:

	UK target tonnage	Reduction compared to baseline	Reduction compared to BAU¹	Reduction compared to BAU²
By 31 December 2007	4886.96	17.7 %	32.9 %	7.1 %
By 31 December 2008	4886.96	17.7 %	34.8 %	9.8 %
By 31 December 2009	4886.96	17.7 %	36.7 %	12.5 %

¹ Business as usual (BAU) without taking into account any action since 2001 (since the OSPAR Recommendation)

² BAU taking into account actions taken before 1 January 2006 (but without action being taken into account after that date)

N.B: the above figures take into account an average yearly increase of 3% in produced water discharges without actions being taken.

The quantity of allowances has been calculated using the same method for all installations: baseline tonnage - 17.7% of that tonnage = allocated quantity of allowances.

The 4886.96 tonnes yearly overall cap includes a new entrant reserve of 20 tonnes / year (approximately 0.5% of total allocations). This reserve should, according to last years' figures provided by the UK authorities, be sufficient to cover at least a significant part of the new entrant requirements anticipated in the three years of Phase I.

Allocations from this reserve will be based on projections for a four-year period. These projections will be reviewed after three years of production. The allocation method will be the same as for incumbents: baseline – 17.7%.

There is no specific rule to take into account early action. However, the OSPAR baseline year being year 2000, those companies that took early actions to abate discharges before the trading period, will be by definition in a better situation.

3. Assessment of the measure

The UK authorities notified the above described scheme to the Commission before implementing it and have therefore complied with their obligation on the basis of article 88(3) of the EC Treaty.

3.1 Existence of aid within the meaning of article 87(1) of the EC Treaty

For a measure to be State aid within the meaning of Article 87(1) of the EC Treaty, it has to provide an economic advantage to its beneficiaries, to be selective, to distort or threaten to distort competition and affect trade between Member States, and to be granted via State resources.

Selectivity

In order to limit the discharge of oil in produced water into the sea, the UK authorities decided to introduce a trading mechanism that applies to a certain sector of the UK industry, namely to offshore installations that are subject to a permit to discharge dispersed oil in produced water. The measure is therefore selective.

Advantage

Discharge allowances represent the right to discharge dispersed oil in produced water and are tradable amongst the covered installations. They represent an intangible asset to their holder which will develop a positive market value as of the beginning of the trading. The UK authorities decided to allocate all allowances for free, thus below any positive market value. They thereby confer an economic advantage to the beneficiaries of the allowances.

It might be that, due to specific allocation rules to certain sub-sectors or companies, not all beneficiaries would receive the same advantage. However, any allocation for free constitutes an economic advantage to the beneficiary of the allowance.

State resources

The discharge allowances represent a positive market value which the UK authorities could have sold or auctioned. When offering these allowances for free, the UK government foregoes

the revenues corresponding to the amount it could have received by selling or auctioning them.

Distortion of competition and effect on trade

The advantage to the companies from obtaining the allowances for free strengthens their competitive situation vis-à-vis their competitors compared to a situation where they would have had to buy them¹.

The concerned sector is an entirely liberalised sector where the beneficiaries (and, amongst them, groups like Shell, Total, BP, etc.) compete world-wide. The allocation for free is likely to have direct effects on production, pricing and investment decisions of the covered companies. Thus the allocation of allowances for free has the potential to distort competition and affect trade.

In view of the above, the Commission considers that the dispersed oil in produced water trading scheme constitutes State aid within the meaning of Article 87(1) of the EC Treaty.

3.2 Compatibility of the aid

The objective of the scheme is to reduce the quantity of dispersed oil in produced water discharged into the sea. This objective falls within the scope of the concept of “environmental protection” as defined by point 6 of the Community guidelines on State aid for environmental protection² (“Environmental Guidelines”):

“...the Commission takes “environmental protection” to mean any action designed to remedy or prevent damage to our physical surroundings or natural resources or to encourage the efficient use of these resources.”

Nevertheless, the Environmental Guidelines do not establish any specific rule for the authorisation of a trading system such as the one notified by the UK authorities. The aid is not related to investments in order to improve the environment or to investments in energy saving or renewable energy and therefore the rules in section 3.1 do not apply. The rules in section E.3 on operating aid are not applicable either, since the aid is not granted in the form of tax exemptions, it does not concern renewable energy and in fact, it is not determined by future production but rather on the basis of historical discharges. The guidelines refer to aid resulting from trading systems like the one at hand only for the reduction of greenhouse gas emissions under CO₂-emission trading mechanism, but without providing any guidance as to the conditions of the authorisation of any State aid such a mechanism may contain.

Therefore, the Commission assesses the compatibility of the notified measure with the common market on the basis of article 87(3)(c) of the EC Treaty, as foreseen in point 72 of the Environmental Guidelines.

Under article 87(3)(c) of the EC Treaty, the Commission can authorise an aid measure “to facilitate the development of certain economic activities or of certain economic areas, where

¹ The obligation of the companies to reduce their discharged quantity of dispersed oil in produced water collectively is taken into account in the assessment of the compatibility of the measure.

² OJ 2001/C 37/03, 3.2.2001

such aid does not adversely affect trading conditions to an extent contrary to the common interest”.

As the measure follows an environmental objective of common interest, namely the protection of marine environment, the Commission must make sure that its potential negative effects on competition within the internal market are counterbalanced by its positive effects.

In this context, the Commission takes into account in particular the following aspects of the measure:

Existence of an environmental counterpart

The importance of the protection of the maritime area, the prevention and elimination of pollution of the marine eco-system explicitly appear in the Community’s 6th Environmental Action Programme³, and in the Commission’s proposal of the Marine Strategy Directive⁴. In this latter, the Commission states that *“priority should be given to achieving good environmental status in the Community’s marine environment, to continuing the protection and preservation of that environment, and to ensuring that subsequent deterioration is prevented.”*

However, the OSPAR Recommendation has not been transposed into Community legislation and there is no mandatory reduction target or standard foreseen in this field by Community law for companies of the Member States.

Moreover, the dispersed oil trading system goes beyond the OSPAR Recommendation⁵ which only requires the achievement of a certain reduction in the tonnage of dispersed oil in produced water discharged into the sea, but not the maintenance of this level of tonnage after 2006, against the discharges from new installations and the naturally growing discharge tonnage. To date, the UK is actually the only OSPAR contracting party to introduce a legally binding system for the maintenance of the OSPAR target tonnage after 2006.

The quantity of allowances guarantee an overall cap of 4886.96 tonnes/year of dispersed oil in produced water discharged into the sea by offshore installations, for all three years covered by Phase I of the trading. This cap represents a 17.7% reduction compared to the baseline tonnage. By the end of the first trading period (31 December 2009), this tonnage would represent a 36.7% reduction compared to the business as usual tonnage without actions since 2001 (since the OSPAR Recommendation), and a 12.5% reduction when taking into account all environmental actions taken up to January 2006. (These figures take into account an average yearly increase of 3% in produced water discharges without actions.)

It follows from the above reduction requirements that allocation beyond business as usual needs (“over-allocation”) is very unlikely to happen. Even if one takes into account all environmental actions taken until 2006, the required reduction of 12.5% until the end of the

³ Established by Decision n° 1600/2002/EC of the European Parliament and of the Council; OJ L 242, 10.9.2002, p.1.

⁴ Proposal for a Directive of the European Parliament and of the Council establishing a framework for Community action in the field of marine environmental policy; COM(2005) 505 final

⁵ N.B. The OSPAR Recommendation itself has no binding force. See art.13 § 5 of the 1992 OSPAR Convention which explicitly states that “Recommendations shall have no binding force”.

scheme is important enough to make it very unlikely that the covered installations will not be over-allocated.

In theory, over-allocation could occur in the case of companies that would have taken substantial early actions since the setting of their baseline or in case of installations with important tied-back drilling centers or fields that would have been closed or decommissioned in the meantime (see point 2.6 above).

Concerning substantial early action, the Commission is of the view that some reward for early action can be justified and the reduction targets of the scheme are sufficiently strict to make any over-allocation most unlikely to happen. Decreasing the risk of over-allocation to an even further extent would reduce as well the reward for early action. The Commission in these circumstances does not find it necessary to require the amendment of the notified rules.

Concerning partial closure or decommissioning between the baseline year and the beginning of the trading, the Commission notes that the OSPAR Recommendation 2001/1 recognizes decommissioning and cutting back production as acceptable means of achieving the reduction targets. The Commission deems this approach acceptable under State aid rules as it contributes to the achievement of the environmental target by the concerned companies. The Commission also takes into account the fact that the company's baseline tonnage is adjusted if one of its stand-alone installations is decommissioned and that in case of closure or decommissioning after the beginning of the trading, the allocations for the next calendar year are adjusted/withdrawn.

The rules on production increase are construed in a way that they cannot lead to over-allocation. In case of partial increase by 0 to 33% of the production, the baseline quantity is not increased. In case of partial increase by 33% to 66%, the baseline quantity is increased by 33%. Where the increase exceeds 66%, the baseline quantity is increased by 66%. In case of new stand-alone installations that started production between 2000 and the beginning of the trading, the baseline is the quantity of discharge in the first complete calendar year of production. For new installations starting production after the beginning of the trading, the operator has to apply for allowances from the new entrant reserve. These rules ensure that companies with increased production are not over-allocated and contribute therefore to the achievement of the environmental objective.

Based on the above considerations, the Commission is of the view that the notified scheme ensures the achievement of an important environmental objective by guaranteeing that a 17.7% reduction in discharged tonnage of dispersed oil compared to baseline is achieved and maintained throughout the three years of the notified trading period by each covered company, leading to an overall (approximately) 12.5% reduction compared to business as usual discharges taking into account actions up to 2006.

The penalty mechanism foreseen by the UK authorities ensures that failure to surrender allowances equivalent to discharges cost significantly more than the marginal cost of the required abatement. Therefore it increases the effectiveness of the scheme both at an overall level and at the level of the individual companies.

Avoiding undue differences of treatment

All rules relating to the setting of the baseline tonnage are based on objective technical criteria and do not lead to the favourable treatment of certain sectors or companies compared to others covered by the trading scheme.

The method for the allocation of the allowances is the same for all covered installations: baseline tonnage – 17.7% of that tonnage = allocated quantity of allowances.

The allocation to new entrants from the new entrants reserve creates no undue advantages to the newcomers, nor to the existing installations. Firstly, in the absence of historical data, allocating on the basis of projections, and reviewing it after three years of production, can be accepted as a reasonable approach. Since new installations are subject to the IPPC-Directive⁶, they will have to respect standards that can be obtained by ‘best available technique’ and therefore also the allocation will be based on BAT and no allocation will be given for inefficient or environmentally unfriendly techniques. Secondly, the allocation will be based on the same method as for incumbents, i.e. a reduction of 17.7%. Thirdly, although the reserve is rather small, it should be sufficient to cover at least a significant part of the new entrant requirements anticipated in the three years of Phase I. Therefore the Commission expects no significant negative effect on market dynamics.

The rules on increased and decreased production apply to all sub-sectors and companies covered by the scheme and ensure the technical viability and environmental integrity of the scheme. They do not lead to undue advantage of certain trading companies over others.

More generally, no specific rules are foreseen for the special treatment of a certain sub-sector or company.

Proportionality

The Commission assesses whether (i) the measure is proportional to the desired environmental effects and whether (ii) the aid in individual allocations is proportional to the measures the beneficiaries have to make under the scheme.

(i) The Commission is of the view that the measure is proportional to the purposes and to the expected environmental effects of the scheme. Firstly, trading mechanisms such as the one under assessment, are recognized by the Community as adequate means to efficiently reduce environmental pollution at least cost (i.e. the EU Emission Trading Directive⁷). Although the type of measure is rather new and its application to the environmental problem concerned is rather innovative, the Commission does expect it to be effective. Secondly, Community law does not prescribe the UK to deal with the problem of dispersed oil in any specific other way.

⁶ Council Directive 96/61/EC of 24 September 1996 concerning integrated pollution prevention and control; OJ L 257, 10.10.1996, p.26

⁷ Directive 2003/87/EC of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community

(ii) The aid in individual allocations is proportional to the measures the beneficiaries have to make under the system. Although allowances are given for free, allocations are below expected needs, so companies will have to bear the cost of measures to comply with the system. It requires a significant reduction of the quantity of discharged oil in produced water before a company is able to generate a financial advantage out of its free allowances.

In addition, the beneficiaries are not relieved from a burden that they should bear under Community law and in line with article 20 of the Environmental Guidelines the “*Aid [...] serves as an incentive to achieve levels of protection which are higher than those required by Community standards*”. There is no specific target or standard foreseen in this field by Community law for the companies of Member States. The Commission’s proposal for a Marine Strategy Directive does not foresee any mandatory target or standard in this field either.

Conclusion on compatibility

When balancing the above circumstances and effects of the measure against its potential negative effects on competition, the Commission takes into account the existence of an important environmental counterpart both at the level of the overall scheme and at the level of individual installations; the proportionality of the overall measure with its environmental purpose and the proportionality of the individual aids with the individual efforts the beneficiaries must carry out to meet their obligations under the scheme; as well as the fact that the allocation plan does not foresee any special rule for specific sectors or companies or for allocation from the new entrant reserve, thereby limiting the distortive effects of the measure.

The Commission also takes into account the fact that the UK authorities undertook to re-notify the Commission of each new allocation plan under State aid rules. The present decision therefore only covers the allocation of allowances and the trading mechanism during its first three years.

Based on the above considerations, the Commission is of the view that, although the system contains State aid, its potential to distort competition is sufficiently counterbalanced by its above described environmental effects.

4. Decision

In light of the foregoing the Commission concludes that the notified dispersed oil in produced water trading scheme is compatible with article 87(3)(c) of the EC Treaty and therefore decides not to raise objections to its implementation.

The Commission reminds the UK authorities that, in accordance with Article 88 (3) of the EC Treaty, plans to alter this scheme have to be notified to the Commission pursuant to provisions of Commission Regulation (EC) No 794/2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 [*now 88*] of the EC Treaty⁸.

⁸ OJ L 140, 30.4. 2004, p.1

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Your request should be sent by registered letter or fax to:

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Yours faithfully,
For the Commission

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