Free allocation of allowances under the EU Emissions Trading System – legal issues

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Abstract: This paper provides a legal analysis of some of the key issues that arise in examining the system for allocating emissions allowances under the EU's Emissions Trading System Directive. There is a strong series of arguments in support of the view that the free allocation of allowances under the various NAPs involves an element of State aid, which has neither been formally notified to, nor cleared by, the Commission under the EC Treaty. Even if it is found properly to have been notified, there are serious doubts as to whether the extent of aid granted satisfies the proportionality principle. As a result, the operation of the EU ETS may be subject to some legal uncertainty with regard to possible legal challenges to the current allocation of allowances. Going forward, proposals to amend the operation of the EU ETS must take into account similar State aid considerations (particularly proportionality) and the experience gained from the working of the EU ETS in Phase I. The structural outline of a possible legislative package has been suggested, which could achieve the safeguarding of commercial and legal certainty under the current allocation regime, while at the same time providing a basis for amendment of the allocation mechanism under the EU ETS for Phase II or beyond.

Key word list: Emissions trading; European Union; Law; Competition; State aid; EC Law

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Angus Johnston[*]

1. Introduction

The introduction of the EU's Emissions Trading System (hereafter "EU ETS" or "ETS") was a highly significant development in EU and international environmental law. The Council and the European Parliament adopted the EU ETS Directive[1] on 13 October 2003 and Member States were required to implement its provisions by 31 December 2003 (although the implementation process has in fact proved a rather more sedate affair than this short time-frame might have suggested).

This paper is concerned with one aspect of the operation of the EU ETS, which has emerged in the early practice under the scheme. This is the extent to which the free allocation of allowances to operators (for those installations covered by the Directive) amounts to the grant of State aid in contravention of the provisions of the EC Treaty. This has become a pressing issue due to recent analysis, which suggests that the opportunity cost associated with holding such an allowance (prior to submitting it in fulfilment of the requirements of the Directive at the end of the relevant accounting period) has been passed through to consumers in the electricity sector, in the form of increases in power prices. Assuming that such a pass-through has occurred, this paper considers whether or not the free

allocation of allowances thus amounts to State aid and then goes on to assess the consequences of such a conclusion for the operation of the current system and for proposals for possible reforms to the EU ETS in the future. It will be argued that some degree of State aid is indeed present in the current regime, that it would be difficult to justify certain elements of that aid on the basis of the current EC legal provisions, and that great care must be taken to ensure that any future amended EU ETS complies with the State aids rules while at the same time achieving the intended environmental benefits.

2. Free allocation and State aid

Does the free allocation of allowances under the EU ETS conflict with State aid considerations under EC law?

2.1 The basic prohibition on the grant of State aids in the EC Treaty

The scheme of the EC Treaty assumes that aid granted by a Member State is prohibited unless some exception or exemption is provided for in or under the Treaty.[2] The general prohibition against such aid is laid down in Article 87(1) EC:

> "Save as otherwise provided in this Treaty, any aid granted by a member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring

certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market".

From this provision, and from the case law and decisional practice of the Commission, certain criteria must be met to show that something amounts to "State aid" for these purposes. It must be established that:

- an 'advantage' has been conferred[3] …
- which was granted by the State or through State resources[4] …
- which distorts or threatens to distort competition[5] …
- by favouring certain undertakings or the production of certain goods or services (i.e. a 'selectivity' criterion)[6] …
- and which affects or may affect trade between EC Member States.[7]

In the EU ETS Directive, there are consistent references to the need for the National Allocation Plans ("NAPs") (under which allowances are allocated to operators of relevant installations) to respect the EC State aid rules – see, in particular, Article 11(3).[8] This means that the Directive and its mechanisms do not operate, in and of themselves, as some kind of exception from the State aid rules. In turn, this means that the analysis of such NAPs in the light of the State aid rules is vital in coming to any conclusion about the compatibility of the allocation of allowances with EC law.

It is important to appreciate, however, that even if a particular action by a Member State does amount to aid under the EC Treaty, it may still be possible for that aid to be granted an exemption under specific Treaty provisions or under legislation adopted under the auspices of the Treaty. This point will be treated below (see section 3), with specific concentration upon justifications relating to environmental matters and to ‘the execution of an important project of common European interest’.

2.2 Applying the criteria to the free allocation of allowances under the EU ETS

In applying these criteria to our scenario, and to gain some sense of the Commission’s previous general attitude towards this issue, we need to examine its earlier Decisions concerning the notification of national emissions trading schemes prior to the adoption of the EU ETS Directive. The closest analogue to the EU ETS is probably the UK’s forerunner emissions trading scheme,[9] which was voluntary for participants, who were given an incentive to join the scheme by means of payments from the State. These payments clearly amounted to aid and were held to be such by the Commission. However, the Commission also went on to examine *per se* the free allocation of allowances to participants in the scheme:

> “(b) The trading mechanism: The state allocates a limited number of transferable emission permits free of charge to the Direct

participants. The state thus provides these companies with an intangible asset for free, which can be sold on a market to be created. The fact that there will be a market is a sign of the value of the asset being allocated. This has to be considered to be an advantage to the recipient companies.

The fact that companies will have to make expenses in order to realise the value of the allowances does not change the existence of an advantage, but can be considered a positive element in the assessment of the compatibility of the measure.

This advantage distorts competition between companies. Companies able to make a profit from the allowances can use the profit for their business competing with other companies not having access to such a scheme. This can affect trade between Member States.

The value of these permits is predicted to be considerable. By the envisaged arrangements, the State foregoes revenue, which could derive from auctioning the emission permits. One could argue that the voluntary nature of the scheme would hinder a different allocation of allowances than free allocation, as companies would not be likely to participate in such an auction. However, the State opted deliberately for a voluntary approach and by taking this

option forewent [its] other option to gain revenue from an auction in the context of a mandatory scheme.

The Commission therefore concludes that … the trading mechanism [also] constitutes State aid under Article 87(1) EC".[10]

When searching for Commission State aid decisions when approving the National Allocation Plans (hereinafter 'NAPs') submitted by the various Member States under the EU ETS, however, there is a significant dearth of material.

Examining the Commission's Decisions on the NAPs submitted for Phase I, there are consistent references to the need to assess the allocation of allowances under the EC State aid rules (see, e.g., Recital 7 of the Commission's Decision on the UK's original NAP).[11] However, the 'assessment' is hardly extensive: "On the basis of the information provided by the Member State, the Commission therefore considers that any potential aid is likely to be compatible with the common market should it be assessed in accordance with Article 88(3) of the Treaty".[12] Further, in the Commission's earlier 'non-paper' of 1 April 2003,[13] the Commission indicated that:

"National Allocation Plans will constitute State aid under Article 87(1) EC and will therefore have to be notified to the Commission for assessment under State aid rules. Competition policy procedural

rules will apply in this respect. The Commission intends to take at the same time the two decisions legally required on the Plan as regards the assessment as required in the common position and the State aid assessment".

However, the Commission does not seem to have adopted any separate State aid decisions dealing with the issues raised by the notification of the various NAPs for Phase I. The most extensive comment to date on this issue is to be found in Recital 5 of the Commission's Decision on the French notification of its NAP:[14]

> "Pursuant to criterion 5 [of Annex III], the Commission has also examined compliance of the French National Plan with the provisions of the [EC] Treaty, and in particular Articles 87 and 88 thereof [i.e. the provisions on State aid. The Commission considers that the allocation of allowances free of charge to certain activities confers a selective economic advantage to undertakings which has the potential to distort competition and affect intra-Community trade. The allocation of allowances for free also appears to be imputable to the Member State and to entail the use of State resources to the extent that more than 95% of allowances are given for free and allows banking of allowances from the first to the second period. The Commission therefore at this stage cannot exclude that the plan implies State aid pursuant to Article 87(1) of the Treaty. The national allocation plan allocates excessive

allowances to industrial activities. The Commission considers that this favourable treatment has not been duly justified by France and that the measure appears to grant an undue advantage to industrial activities, which would allow this activity to dispose of allowances without having to deliver a sufficient environmental counterpart. The Commission at this stage therefore cannot exclude that any aid involved would be found incompatible with the common market should it be assessed in accordance with Article 88(3) of the Treaty".

In spite of these criticisms, the Commission's final decision on the French NAP does not appear to have imposed any specific criteria or reached any formal decision relating to State aid, focusing instead upon other aspects in which the French NAP had been adjudged deficient according to the other (i.e. non-State aid) criteria laid down in the Annexes to the EU ETS Directive.[15]

Nevertheless, on the basis of the Commission's earlier Decision relating to the UK's national ETS and its tentative analysis in its Decision on the French NAP, it seems tolerably clear that the free allocation of allowances under the EU ETS does amount, *prima facie*, to State aid within Article 87(1) EC. Free allocation clearly involves the State foregoing revenue that might have been raised by the auctioning of such allowances and the grant of such allowances only to emitting installations may amount to a selective grant of an advantage (favouring them over other businesses) that may

distort competition and affect trade between Member States where those in competition are established in different EU countries. Further, if it is established that opportunity costs are passed through (and the analysis in the other papers in this issue suggests that they most certainly are), then it seems clear not only that aid is granted by the free allocation of allowances, but also that it goes far beyond that expected simply from the free allocation of allowances in the first place. The extra element, beyond the value of the allowance itself, is the ability to use the fact of holding that allowance to pass through to customers the opportunity costs associated with holding that allowance. This last point (which relates to the question of proportionality) is highly significant for the assessment of the justifiability of such aid and will be considered in para. 3.2.5, below.

Earlier work on this topic (Merola and Crichlow, 2004) had suggested that an ETS at the *EU* level (rather than one adopted unilaterally at the *national* level) required a different assessment of the State aid criteria from that adopted by the Commission in the earlier Decisions relating to national systems. Specifically, it was argued, first, that the EU-wide grant of such allowances meant that no unilateral *advantage* was conferred upon undertakings under the EU ETS (Merola and Crichlow, 2004, 34-36). Second, it was suggested that the selectivity criterion would also not be met under the allocation regime for the EU ETS, given that the Directive itself specifies the sectors covered by the scheme and does not allow sufficient room for Member States to derogate from this regime to amount to the *selective* grant of an advantage by the state to the undertakings involved.

On the first point, it is clear from the Commission's Decision on the French NAP notified under the EU ETS Directive (extracted above) that the Commission has taken the view that an advantage is conferred in such circumstances. This view is strongly bolstered by the discovery that opportunity cost pass-through is facilitated by free allocation, as this involves a clear advantage received by those allocated allowances, and this is an advantage not intended to be related to the environmental goals of the scheme.

On the second point concerning selectivity, meanwhile, two comments may be made. First, insofar as different undertakings within each sector have different emissions rates and caps assigned to them under each NAP, in accordance with their previous emissions record and their reduction targets, there is some degree of selectivity in the grant of the benefit within each sector. The response to this claim would no doubt be that this is, again, inherent in the EU-level adoption of the scheme and thus could not be described as "selective" in the sense normally given to that term because it is not a selection made by the Member State, but at EU-level. The Member States remain ultimately responsible for adopting their respective NAPs, but their discretion in allocating allowances is severely curtailed by the terms of the EU ETS Directive. Merola and Crichlow did, however, accept (2004, 36) that selectivity questions do remain with regard to that proportion of allowances not covered by the free allocation obligation.

Without more, the point is clearly a finely balanced one, and one must accept the force of their argument overall.

However, the second point concerning selectivity is indeed something "more": once again, the phenomenon of opportunity cost pass-through shows that the selectivity inherent in the EU delimitation of the sectors covered by the EU ETS actually is not merely limited to the advantage associated with holding the allowance itself, but extends to the further benefit received by virtue of holding the allowances – the ability to pass through the opportunity costs of holding such allowances. This effectively exacerbates the extent of any selectivity inherent in the EU ETS to the extent that a clearly selective benefit is received by some within each sector (compare, e.g., a coal-fired generator's receipt of allowances under the EU ETS with that of a wind-farm operator: the latter receives no allowances and thus no chance to pass through opportunity costs, while remaining in competition with the former in the sale of electricity generated). This also reinforces the conclusion that competition between those undertakings may be distorted and that trade between Member States may be affected.

Thus, it is submitted that the free allocation of allowances under the EU ETS does indeed amount, *prima facie*, to the grant of State aid under the rules of the EC Treaty.

2.3 Scenarios concerning free allocation and State aids law

In the light of this discussion, it is important here to distinguish two basic different relevant sets of circumstances for State aid purposes.

(i) Would *continued* free allocation on the basis laid down in the current Directive conflict with EC State aid rules?

(ii) What State aid constraints are there in *amending* the allocation mechanism in the Directive (e.g. to allow free allocation to consumers in one form or another)?

These situations may require different treatment when examining the relevant procedures that must be followed to gain approval for any mechanism allocating allowances under an EU ETS in any form. The former situation, if it has not been notified properly to the Commission, may require action to regularise the position: otherwise, it is possible that any aid elements that have been granted without Commission authorisation may have to be paid back. I return to this question in para. 4.3, below, where the possible shape of any legislative package in this area is considered briefly (e.g. securing both the amendment of the Directive and legal certainty for operators under the current regime). The latter situation, meanwhile, has consequences for the (re-)design of the EU ETS system: as the current Directive makes clear,[16] the EU ETS does not itself operate as an exemption from the State aid rules in the Treaty and so Commission

decisions concerning the application of any future EU ETS must also respect the procedural and substantive conditions of EC State aids law.

3. Justifying State aid granted by the free allocation of allowances

As mentioned in para. 2.1, above, the scheme of the EC Treaty provides that, assuming that there is aid involved, that aid must be *justified* on some accepted ground if the grant of such aid is to be compatible with the common market.

3.1 Background: the Commission's attitude towards State aid in this general area

In analysing the possible justification of State aid granted in the form of the free allocation of allowances under the EU ETS, it is important to have an appreciation of the Commission's general approach to the approval of the grant of aid for environmental purposes.[17] In its own words, this approach must "satisfy a double imperative": it must ensure the competitive functioning of markets, while at the same time integrating environmental protection requirements into competition policy (in particular, focusing upon the internalisation of the costs of environmental impacts). However, the Commission is prepared to allow aid:

> (a) in certain specific circumstances in which it is not yet possible for all costs to be internalised by firms and the aid can therefore

represent a temporary second-best solution by encouraging firms to adapt to standards; and

(b) where the aid may also act as an incentive to firms to improve on standards or to undertake further investment designed to reduce pollution from their plants.[18]

Nevertheless, it must be noted that the Commission's attitude has hardened in its 2001 Guidelines, even where environmental aid is concerned:

"aid should no longer be used to make up for the absence of cost internalisation. If environmental requirements are to be taken into account in the long term, prices must accurately reflect costs and environmental protection costs must be fully internalised. Consequently, the Commission takes the view that aid is not justified in the case of investments designed merely to bring companies into line with new or existing Community technical standards".

This is because the key factors – namely: the 'polluter pays' principle, the notion of internalising such costs and the use of market instruments – have now long been promoted by EC environmental policy. The Commission's current view is clearly that companies have had long enough to adapt to such requirements and should no longer need aid to assist them in bearing such costs.[19] It is clearly arguable that the EU ETS falls squarely within this

stricter analysis of the justification of environmental aid (which serves further to bolster the points made below (para. 3.2.5) concerning proportionality).

3.2 Evaluation of State aid – justifications for the grant of aid

3.2.1 Environmental grounds

Clearly, environmental justifications for the grant of State aid will be vital in this context.[20] Specifically, these justifications may fall under the headings of:

- ‘projects of common European interest’ (Article 87(3)(b) EC) (“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”),[21] or

- ‘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’ (Article 87(3)(c) EC).

It seems reasonably clear that, in our context, the EU ETS could be said to be a “project of common European interest”, since the Directive is a

common action agreed by all the Member States to combat the common threat of global warming by endeavouring to incentivise the reduction of CO2 emissions.[21]

Merola & Crichlow (2004) have argued that "if the Commission applied Article 87(1) to the whole scheme, Article 87(3)(b) would authorise the entire allowance allocation scheme". Under this approach, such an exemption would cover all emissions and make it unnecessary precisely to establish the proportionality of the aid to the environmental benefit to be secured under the EU ETS "because the compensatory justification would be implicit in the fulfilment of the specific requirements of Article 87(3)(b), as indicated in paragraph 73 of the [Commission's] Guidelines".[22] This claim illustrates the key importance of careful identification of the precise ground upon which any exemption is sought from the prohibition on the grant of State aid. This issue will be addressed in the discussion of the proportionality principle (para. 3.2.5, below), where it will be argued that proportionality must still be respected under the EU ETS.

3.2.2 Specific considerations concerning aid to facilitate "investment in energy"

The Commission Guidelines also contain specific comments on aid to facilitate investment in energy.[23] While these provisions are not directly relevant to the exemption of any aid involved in the allocation of allowances granted under the EU ETS (unless Member States specifically

attempt to argue that any such extra support amounts to the support of investment in renewable energy), they do, however, illustrate the Commission’s amenability to environmental arguments concerning the promotion of energy produced from renewable sources. At the same time, it is clear from the Guidelines that the need for such support will require careful proof and justification in each individual case.

3.2.3 Specific Guidelines concerning greenhouse gas reduction measures

Unfortunately, however, the specific provisions in the Guidelines concerning measures aimed at reducing greenhouse gases *pre-date* the EU ETS Directive:

> “70. In the absence of any Community provisions in this area and without prejudice to the Commission’s right of initiative in proposing such provisions, it is for each Member State to formulate the policies, measures and instruments it wishes to adopt in order to comply with the targets set under the Kyoto Protocol.
>
> 71. The Commission takes the view that some of the means adopted by Member States to comply with the objectives of the [Kyoto] Protocol could constitute State aid [24] but it is still too early to lay down the conditions for authorising any such aid”.

Clearly, para. 70 is no longer fully applicable in this area, in the light of the EU ETS Directive. Nevertheless, given the Commission's attitude in its various Decisions on the NAPs submitted to it under the EU ETS Directive,[25] it seems clear that the Commission continued to consider (at least in principle and at the time that the NAPs were submitted to it for approval) that separate EC State aid control remained appropriate for such allocation of allowances, even after the advent of the EU ETS.

Further, and also unfortunately, the Commission's Decisions on the NAPs notified under the EU ETS Directive make no more than cursory and passing reference to the State aid question in relation to the allocation of emissions allowances under the Directive (see para. 2.2, above), so no detailed guidance is available from this source on the application of the environmental justification of such State aids either.

3.2.4 Do the environmental justifications apply here?

This question must be asked both in relation to the allowances allocated under the current EU ETS Directive and if some alternative form of free allocation were to be continued under a revised version of the Directive.

Concerning the continuing free allocation of allowances to "operators of installations" only, as under the current Directive, does this raise State aid problems? Given the evidence discussed above concerning the pass

through of opportunity costs, then the structure of analysis should be as follows:

(i) Such allocation is acknowledged by the Commission to amount *prima facie* to State aid (as discussed in section 2, above);

(ii) Thus, the aid needs to be notified to the Commission, and found to be justifiable – here, one would rely upon environmental justification grounds;

(iii) It is clearly possible, in principle, to bring the current free allocation of allowances under the environmental grounds discussed above, *yet* it seems strongly arguable that the *extent* of the extra benefit received (due to the passing through of opportunity costs) would amount to a benefit that is disproportionate to any environmental gains made through the EU ETS.

The second of these points is significant, because failure to notify the aid renders its grant unlawful: this has consequences for possible court action to require the repayment of such aid (see section 4.1.2, below). The last of these points raises the important question of the application of the EC law principle of proportionality in the State aids field: we must now consider the operation and significance of this element in the analysis.

3.2.5 The principle of proportionality

3.2.5.1 General considerations

When the Commission takes a decision on the compatibility of any proposed grant of aid with the EC Treaty, it must respect the principle of proportionality. This is a general principle of EC law,[26] which is inherent in the EC Treaty and thus applies as a matter of law to the actions of the EC institutions (here, the Commission in approving State aid)[27] and to those of the Member States (when implementing or derogating from EC law: see, e.g., Tridimas, 1998, ch. 4).

Although the Commission has adopted its own Notice on *de minimis* aid and on thresholds of permissible aid (see para. 3.2.2, above), the EC courts are not bound by such Commission guidelines and may thus find there to be a breach of the principle of proportionality even in the face of the Commission's guidelines.[28]

Thus it is possible for proposed aid to be within the Commission's 'permissibility' thresholds and yet still contrary to the principle of proportionality.

3.2.5.2 The application of the proportionality principle

The basic structure of the approach required under the proportionality principle is as follows:

(i) first, it must be established that there is a justifiable goal to be achieved [here, environmental protection by reducing CO2 emissions];

(ii) second, we must ask: is the measure [here, the free allocation of allowances] suitable and *necessary* for achieving that goal?

(iii) is the measure *proportionate* in achieving that goal? I.e., even though the measures do achieve the justifiable goal, do they involve an excessive negative concomitant effect?

In practice, the key question will be the *standard* (i.e. the intensity) of review employed in asking what would amount to an 'excessive' negative effect: i.e. does it have to be the minimum negative effect possible, while still achieving the goal, or is a less strict standard appropriate?

3.2.5.3 Implications of the proportionality principle

In this scenario of allowances allocation, the argument is that the *policy choice* taken (i.e. free allocation) by the EC and/or the Member States is itself disproportionate. It is true that, in such cases, most courts (including the EC courts) tend not to review such choices too intensively (usually looking to see whether manifest error or manifest inappropriateness has

been made out: see, e.g., Craig and de Búrca, 2003, 625-628, and Lenaerts and van Nuffel, 2005, paras. 4-050-4-054).

However, note that in the State aids context we are also dealing with the *rights* of individuals to operate in a competitive market place without distortions due to aid granted by a Member State, which has not been approved by the EC. Where individual rights are concerned, courts are usually likelier to conduct a more intensive review of the measure in question, being satisfied only with measures that achieve the goal in view with a less distortive effect upon competitive conditions.

Here, the key point is that free allocation under the current regime effectively grants a windfall benefit to recipients of allowances, which is not related to the environmental gains that the EU ETS aims to secure: this is a good basis for an argument that such aid may be disproportionate.

So far as the argument (relating to justifying aid under Article 87(3)(b) EC) raised by Merola and Crichlow, 2004 (noted in para. 3.2.1, above) is concerned, their point has some force in restricting the scope of the proportionality principle and its impact upon exemptions from the State aid rules. Clearly, while Article 87(3)(c) makes specific reference to the need to balance any scheme with the effect upon "trading conditions" (a clear matter for proportionality), Article 87(3)(b) is not explicitly so constrained. The Commission's Guidelines refer to showing that the aid must be "necessary" for the project of common European interest to proceed

(Commission, 2001, para. 73), but do not expressly consider proportionality criteria. However, the force of this argument is significantly weakened by the phenomenon of the passing through of opportunity costs associated with the holding of allowances under the EU ETS. This element could plausibly be said not to be "necessary" for the implementation of the project in question. Even if it were to some degree necessary, the Commission's Guidelines cannot evade the application of the general legal principle of proportionality, particularly in circumstances where the windfall enjoyed via this pass-through of opportunity costs is so clearly unrelated to the environmental goals of the EU ETS. By contrast, the aid embodied in the free allocation method could certainly be found to be justified under Article 87(3)(b) or, indeed, under Article 87(3)(c), given its clear and close connection (indeed, 90% of allowances were *required* to be allocated freely) with the environmental goals of the current EU ETS. It is the extra benefit that the allowance confers which creates the difficulty and renders the proportionality principle of continuing relevance in the current situation. It is not sufficient in this context to suggest that the Directive's chosen method of free allocation inevitably creates the possibility of passing through the opportunity costs involved: as the Directive itself states (see in particular its Article 11(3), but also Recital 23 and Para. 5 of Annex III), its provisions must be applied by the Commission *subject to* the requirements of the EC State aid rules.

To ensure that such problems are not raised as against any successor scheme, care should be taken to avoid such extra benefits and accurately to

link the allocation of allowances (and the benefits from receiving such allowances) with the environmental gains to be made from the EU ETS. Indeed, this approach fits best with the general approach taken by the Commission in its Guidelines on State aid for environmental purposes (as discussed in para. 3.1, above) and should thus, it is submitted, also commend itself to the Commission in the case of emissions allowances.

3.3 Allocation to consumers and other non-"installations"

3.3.1 General considerations

In summary, the general points concerning possible allocation of allowances to consumers are:

- The EU ETS Directive currently *requires* the free allocation of at least 90% of allowances;

- Only Article 3 and Annex I of the Directive specify allocation to installations;

- If amendment of the Directive were successful, this could allow (partial) allocation to consumers: e.g. a system could be set up that required residents to register with trust fund for such allowances That trust fund would then receive the free allowances, sell them and then pay residents their share of the proceeds.

- Certain benefits would flow from the allocation of allowances to domestic consumers:
  - Allocation to the power sector only could be tailored to compensate losses;
  - This would avoid the risk of regulatory intervention (e.g. in the form of some kind of windfall profit tax);
  - It would also avoid State aid problems;
  - It could well increase support of consumers for the EU ETS;
  - It would also ensure compatibility with Border Tax Adjustment.[29]

- Similarly, benefits could also be seen in the allocation of allowances to industrial consumers:
  - This would operate to compensate for the detrimental effects upon competition;
  - Harmonisation of the allocation criteria would be required, to ensure that distortions of competition (both within and between Member States) are minimised;

Meanwhile, proposals to introduce uniform allocation to all new entrants in the electricity sector (on a per kW or per kWh basis), without reference to whether or not they qualify as "installations" under the current EU ETS Directive, would seem to be inconsistent with the Directive in its present

form. The combination of Article 3(e) and Annex I of the Directive require installations to perform certain activities if they are to be covered by the Directive, and in the energy sector this only relates to "combustion installations with a rated thermal output exceeding 20 MW". Amendment of these provisions would require legislation (see section 4.2.3). Such uniform allocation to new entrants could alleviate some of the difficulties of selectivity created by free allocation under the present regime, as it would not reserve the pass through of opportunity costs to installations covered by the EU ETS. However, careful attention would need to be paid to the proportionality of such allocation in order to satisfy State aids rules (see section 3.3.2.1).

3.3.2 Allocation to consumers or non-"installations": State aid considerations

If an amendment could be made to the Directive to allow allocation of allowances to consumers, would there also be State aid constraints on how to design those amendments?

If the problems raised by the pass-through of opportunity costs can be clearly established, and if allocation to consumers can be shown to combat its problems, then there seems no reason why the same environmental justification grounds would not be applicable to the allocation of allowances to consumers: the environmental goals to be achieved would still clearly be justifiable, and the prevention of the 'pass through problem'

should mean that the benefit conferred is not disproportionate to the environmental gains made (subject, of course, to detailed working out of the system for allocation to consumers).

3.3.2.1 Could we allocate free allowances to industrial consumers in sectors with large electricity consumption or to other non-"installations" (such as renewable electricity generators)?

In principle, this should be possible (subject, naturally, to legislative amendment of the Directive to permit this approach). Care must be taken to ensure that, if allocation in this way were thought to face similar problems to the doubts expressed by the Commission re France's first NAP,[30] then the arguments for justifying that aid on environmental grounds (probably as promoting an important project of common European interest – Article 87(3)(b) EC (see para. 3.2.1, above)) are clearly explained. Questions of the proportionality of this response to the 'pass through problem' would also need to be addressed, to ensure that the cure is not more painful than the ailment. For example, uniform allocation to all new entrant electricity generators on a kW (or kWh) basis would need careful calculation against the number of allowances already allocated, to prevent the system imposing yet further costs upon final consumers, simply in order to equalise conditions of competition between generators, while adding little or nothing to the achievement of the environmental goals of the EU ETS.

3.3.2.2 Could we allocate free allowances to trust funds?

- E.g. Every resident of a country would register with a fund, thus determining the allocation of allowances to these funds. Then the allowances would be allocated to the funds in proportion to the number of members of the fund(s). The fund would then sell the allowances in the market and distribute the money to the members of the fund, either in one or two installations to be determined dependent upon the value of the allowances. Would we have a preference for deciding to allocate to citizens or to residents, given that different countries are involved: i.e. how could we comply with requirements to treat all EU citizens equally?

The basic issue here is the same as under para. 3.3.2.1 and concerns the environmental basis for justifying such aid.

So far as the point about equality of treatment of EU citizens is concerned, this can be accommodated within the framework for the application of a Directive in the various national legal systems. So far as the Directive (as amended) would allow NAPs to be drafted according to a set of common criteria but at the same time allowing for a degree of diversity between EC Member States concerning the *exact* characteristics and shape of their individual NAPs, different choices relating to the implementation of this new idea of allocation (to persons not designated as "installations" under the existing Directive) would be an acceptable expression of subsidiarity (as per Article 5 EC). That is to say, there is a common goal to be achieved,

the result of which is binding upon Member States (by virtue of Article 249 EC and the adoption of the EU ETS Directive, which specifies that common goal – establishing an EU ETS, etc), but leaving the choice of "form and methods" of implementation to the Member States. So long as the Directive is not so prescriptive of the form and methods to be used,[31] then Member States remain free to choose methodologies (etc) that do not contradict the framework laid down in the relevant provisions (and Annexes) of the Directive.

At the same time, one of the points that has emerged during the assessment of NAPs (and the implementation choices made by the Member States under the EU ETS) has been the relative diversity of approaches involved and their possible distortive effect upon competition between undertakings in different Member States (both concerning the trading of allowances and in the undertakings' core businesses). If this came to be regarded as an unacceptable level of differentiation, then it would also be possible to adopt a Directive that gave Member States much less scope for creating diverging terms and conditions for allocation under the EU ETS. This is a matter to be decided upon during the negotiation process leading up to the adoption of any new EU ETS Directive.

4. Various procedural questions

It is important to make clear that the argument that free allocation of allowances under the EU ETS may constitute State aids under EC law may

have important procedural consequences for the operation of the current system and for any moves to reform that system. This section discusses, first, the prospect for legal action in the courts to secure compliance with EC State aids law: this could be pursued before the EC courts, seeking to overturn the Directive itself or the Commission Decisions on the NAPs adopted under the Directive. Alternatively, if the allocation amounted to State aid but was not properly notified under the relevant EC State aids procedures, then it becomes unlawful aid and potentially subject to actions in the national courts to seek or require recovery of that aid by the relevant Member State. The second and third sections address the possible amendment of the EU ETS, either via a 'regulatory committee' route or using a full EC legislative procedure. These routes to change the Directive and its application present both certain constraints and opportunities.

4.1 Possible judicial review? Action before the courts

4.1.1 Before the EC courts

So far as judicial review at the EC level is concerned, this may ultimately be an unfruitful avenue of attack. This is because it is entirely possible that, *even if* the ECJ were willing to hold invalid such Commission decisions approving NAPs (or even the EU ETS Directive itself), the consequence would be that the ECJ would maintain the decisions (and Directive) in force, pending their replacement. This would be because the ECJ would take the view that the goal to be achieved (establishing the ETS to meet

environmental objectives) would better be achieved by maintaining the system in place pending the adoption of a new EU ETS, rather than by knocking the whole thing down and living without it in the interim.

A successful action for annulment leads the Court to rule that the act concerned is void (Article 231 EC) with general (*erga omnes*) and retroactive (*ex tunc*) effect, but there are qualifications to this basic principle:

- E.g. if aim of the action is to secure an act that imposes stricter limits: the Court will leave the act in place as imposing *some* limits, while ordering that a new act be adopted in accordance with the ruling;[32]

- Also, there is the possibility of avoiding the harsh effects of such retroactive voidness by qualifying the extent of the nullity: Article 231(2) EC. See, e.g., the case concerning the Directive on students' rights of residence,[33] where the Directive continued in force until it was replaced by subsequent legislation. Equally, certain elements of the measure can be left in place – i.e., it is possible to impose temporal and scope restrictions upon the invalidity of the measure in question.

4.1.2 Before the national courts

Meanwhile, another avenue of challenge is the possibility of judicial review (or other court action) in any given Member State before their *national courts*. Such national courts may enforce the requirement that Member States must *notify* such aid (under Article 88(3) EC) and may not implement aid in the absence of having made such notification, so that they may "find acts implementing aid measures to be invalid, suspend the implementation of unnotified aid [or] order its repayment …".[34]

This raises the question of whether or not the Commission's tentative expressions of opinion in its Decisions on the NAPs for emissions allowances do indeed amount to Decisions sufficient to deal with the requirement that such State aid be notified to the Commission prior to its implementation by Member States. If the Commission does not act within two months of notification, the Member State may implement the aid. The aid then becomes an existing aid for the purposes of Art. 88(1) EC,[35] meaning that the Member State may implement it. However, note that the Commission still has a duty with regard to all existing aids to keep them under constant review: here, again, the question of the compatibility of such aids with the State aid rules may be raised by the Commission and may be the subject of a complaint by private parties to the Commission, requesting that it take action.

If it is held that no State aid notification was made at all, then a third party complainant may bring an action in a national court claiming that the grant of such allowances under any given NAP amounts to the implementation of

a non-notified and non-approved aid scheme. Thus, all will turn upon whether or not the notification of the NAP and the Commission's Decisions are sufficient for State aid purposes to prevent national courts from treating the grant of allowances as unlawfully implemented State aid. In such a case, the general principle is that unlawfully granted aid must be recovered by the Member State:[36] such recovery procedures are based upon national law.[37] Insofar as the NAPs notified to the Commission are available, a brief search through the NAPs produced no reference to the NAP involving the grant of State aid that would need specific exemption by the Commission. Furthermore, the relevant procedural Regulation (Regulation 794/2004/EC, [2004] OJ L140/1), which lays down the conditions for the notification of State aid, provides in its Article 2 that "notifications of new aid pursuant … shall be made on the notification form set out in Part I of Annex I to this Regulation". It is clear that the NAPs were not notified to the Commission on this basis, suggesting that the (admittedly formal) argument that no proper State aid notification was made by the Member States of their respective NAPs is a very strong one indeed.

If a national court is not confident of making this assessment, however, there exists the possibility of making a reference to the ECJ under Article 234 EC for the interpretation of the relevant EC law principles (see, generally, Craig and de Búrca, 2003, ch. 11 and the references cited therein). While it often takes some time to receive an answer to such questions, this would provide an authoritative interpretation of the position

concerning the notified NAPs and their status under the procedural aspects of EC State aids law. Equally, it is possible that a national court will feel able to take its own decision on the question, which could lead to an order that unlawfully granted aid must be repaid by the recipient to the Member State. Given that EC State aids law applies in this fashion in all EC Member States, such a scenario could occur in any Member State where the EU ETS is properly implemented, with allowances allocated and the system up and running. Such challenges could be made to allowances already allocated under Phase I, but the same reasoning would apply to any allowances granted under Phase II if those grants were made without proper notification and clearance under the EC rules on State aid.

4.2 The possible 'regulatory' amendment of Annex III for Phase II

4.2.1 Basis

This is possible by virtue of Article 22 of the ETS Directive (Directive 2003/87/EC [2003] O.J. L275/32):

> "Article 22 - Amendments to Annex III
>
> The Commission may amend Annex III, with the exception of criteria (1), (5) and (7), for the period from 2008 to 2012 in the light of the reports provided for in Article 21 and of the experience of the

> application of this Directive, in accordance with the procedure referred to in Article 23(2)”.

Such changes could only take place for the next reference period, starting in 2008, following the procedure laid down in the Directive.

4.2.2 Procedure for such amendments

4.2.2.1 Article 21 of the Directive

Any amendments must be made in the light of the reports by the Member States, which under Article 21 of the Directive they are required to submit to the Commission.

The Commission’s December 2005 Report (Commission, 2005) in this area, adopted under Article 21(2) of the EU ETS Directive, remains largely silent on the question of allocation, apart from showing an inclination to encourage Member States to use the *auctioning* of allowances more widely and extensively in future (i.e. the 10% of allowances that are not mandatorily subject to free allocation in the next allocation round). If auctions were more widely used under Phase II (post-2008), this would to a limited extent reduce the significance and extent of free allocation, with a concomitant effect upon the ability to pass through the opportunity costs involved. Nevertheless, since free allocation would still apply to at least

90% of all allowances, it is submitted that the proportionality of such pass-through effects would remain questionable at best.

4.2.2.2 The 'comitology' procedure

To make such amendments to Annex III, the procedure in Article 23(2) of the EU ETS Directive must be followed – this is a form of 'comitology' procedure.

"Comitology" is an EC decision-making process involving the delegation of power (to adopt decisions and standards, and sometimes to amend legislation) by the Council to the Commission, subject to the approval of a committee composed of Member State representatives.

There are three main forms of Committee procedure: the Advisory, Management and Regulatory Committee Procedures. The current Comitology Decision is Decision 1999/468/EC.[38] Article 23(2) of the EU ETS Directive refers to the use of the 'Regulatory Committee Procedure' (under Article 5 of the Comitology Decision), under which the Commission submits a draft to the Committee, which adopts an opinion by Qualified Majority Vote (QMV) (a form of vote weighting, under which a certain threshold of votes (representing a particular proportion of the Member States and their populations) must be met).[39] The measure cannot be adopted unless the Committee gives a positive opinion. If this does not

happen, the Council can act by QMV to adopt, or, under one variant, by simple majority to block.

The Regulatory Committee Procedure is the one that grants the strongest role to the Committee. Thus, if amendments are to be proposed, it will be important to provide detailed reasons for both the Commission and the individual Member States for the necessity for such amendments, to ensure that:

- the Commission makes the appropriate proposals in its draft;
- the Regulatory Committee approves it by a sufficient majority to satisfy QMV; and
- even if the Committee does not approve the proposals, the Council does do so.

4.2.2.3 Restrictions upon such amendments via the Regulatory Committee Procedure

By the terms of Article 22 of the Directive, no amendments may be made to criteria (1), (5) and (7) as laid down in Annex III, *viz*:

> "(1) The total quantity of allowances to be allocated for the relevant period shall be consistent with the Member State's obligation to limit its emissions pursuant to Decision 2002/358/EC and the Kyoto Protocol, taking into account, on the one hand, the proportion of

> overall emissions that these allowances represent in comparison with emissions from sources not covered by this Directive and, on the other hand, national energy policies, and should be consistent with the national climate change programme. The total quantity of allowances to be allocated shall not be more than is likely to be needed for the strict application of the criteria of this Annex. Prior to 2008, the quantity shall be consistent with a path towards achieving or over-achieving each Member State's target under Decision 2002/358/EC and the Kyoto Protocol.
>
> …
>
> (5) 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.
>
> …
>
> (7) The plan may accommodate early action and shall contain information on the manner in which early action is taken into account. Benchmarks derived from reference documents concerning the best available technologies may be employed by Member States in developing their National Allocation Plans, and these benchmarks can incorporate an element of accommodating early action".

It seems that the only potentially problematic element here may be criterion (5): thus, a clear explanation would be needed as to why the proposed

amendments do not amount to undue favour for certain undertakings/activities, leading to concerns under the EC Treaty's rules on State aids. If the point were to redress such differentiation at present, then this would seem possibly to fit within criterion (5).

4.2.3 Inconsistency of Annex III, if amended as proposed, with the main body of the Directive?

This issue might be more problematic, were the Commission, the Regulatory Committee and/or the Council to take the view that it would not be possible to make the appropriate amendments to Annex III without this undermining the system and provisions of the main text of the Directive – and the main text could only be amended by legislation, adopted jointly by the European Parliament and the Council, after a process that could well be too lengthy too effect the required changes before the commencement of the next reference period.

It is certainly the case that the scheme of the EU ETS Directive very much assumes that "operators of installations" are to be the recipients: see, e.g., the Commission's 'non-paper' of 1 April 2003 (Commission, 2003), which emphasised that:

> "It is important to note that, in accordance with Article 11, initial allocation of allowances can only be made to operators of installations covered by the scheme. Hence installations not covered

> by the scheme cannot be allocated any allowances, although they may purchase and hold allowances as any other person".

It is true that Article 11 of the EU ETS Directive refers only to "the allocation of those allowances to the operator of each installation" (see Article 11(1) and (2)). The definition of "installation" for the purposes of the Directive is contained in Article 3(e):

> " 'installation' means a stationary technical unit where one or more activities listed in Annex I are carried out and any other directly associated activities which have a technical connection with the activities carried out on that site and which could have an effect on emissions and pollution".

The activities listed in Annex I are *not* open to change by use of a comitology procedure, as this is only specifically provided for where Annex III is concerned. This would seem to be a fairly conclusive argument against the possibility of amending Annex III to achieve allocation of allowances to parties that would not qualify as "installations" under the Directive as currently worded. However, it should be noted that there is no specific statement anywhere in the Directive that *only* "operators of installations", and no other entities, can be allocated allowances. If this could be argued, then perhaps an amendment of Article III could be effective. Alternatively, another argument might be that consumers are involved in "directly associated activities which have a

technical connection with the activities carried out" by the installation, although this clearly was not what was intended by the wording of Article 3(3) when the Directive was drafted[40] and may thus be unlikely to succeed.

On balance, and after careful consideration, it seems that the 'Annex III amendment proposal' may fall foul of the argument that it would lead to irreconcilable inconsistencies with the remainder of the EU ETS Directive as currently structured and worded. This suggests that, as a matter of the allocation process, it may require a change to the primary legislative text (by means of the full co-decision legislative process under Article 251 EC, involving the agreement of both the European Parliament and the Council) to secure the option of allocating allowances to those who currently are not "operators of installations" under the EU ETS Directive.

4.2.4 Dealing with this inconsistency problem: alternative strategies

However, in Phase II there may yet be a regulatory solution to this problem created by the rigidity of the primary legislative instrument (the Directive). This could be reached by a number of possible routes, perhaps the most promising of which would seem to be the application of EC State aids law as a basis for challenging any NAP that continued to grant free allowances to "installations". First, Member States would be well advised to notify future NAPs under both the EU ETS Directive *and* the specific EC State aids procedures. Then, any challenge could be brought by any Member State against a Commission Decision approving such an NAP, or the

Commission itself could refuse to approve such a proposed NAP on the ground that any aid granted as a result of such free allocation of allowances was disproportionate in quantity to the environmental objectives to be achieved thereby. A Commission approval decision for a Member State's NAP could be made conditional upon some kind of claw-back by the Member State of the disproportionate aid elements associated with the ability to pass through opportunity costs to consumers. Naturally, if the undertaking receiving the allowances for each installation can show that such costs have not been passed through, then no claw-back would apply. It remains important to consider the State aid question here, because the Directive is, as highlighted throughout this paper, specifically subject to the application of the Treaty's State aid rules.

4.3 Legislative action – amending the EU ETS Directive

Finally, a legislative strategy could be devised to deal with the issues raised by State aids law in this field. As with the current EU ETS Directive, the relevant legal basis under the EC Treaty for such legislation would be Article 175(1) EC, which would require a proposal from the Commission and the involvement and ultimate joint agreement of the Council and the European Parliament under the so-called "co-decision" procedure of Article 251 EC. If this is the only way in which to achieve the desired changes, it is vital that moves begin as soon as possible: this process can be complex, hotly contested and lengthy before a workable legal instrument can be adopted. On the other hand, the process allows great scope for

consultation, lobbying and the submission of observations by interested parties, which should make it possible for the key issues and consequences to be aired on a European level. Within the EU institutions, the Commission and the European Parliament will be key foci for any lobbying efforts, while the important role of the Council in the co-decision procedure means that lobbying at the national level to persuade national governments (who then sit in the Council) of the argument will also be vital.

Such a new Directive could conceivably be introduced to replace the current EU ETS Directive prior to the entry into its Phase II in 2008; however, it seems that time constraints may prevent the formulation of an appropriate proposal by the Commission and its passage through the EC legislative process in time for adoption at EC level, let alone its implementation by the Member States.[41] Thus, any wide-ranging legislative solution may well have to wait until consideration is given to the continuation of the EU ETS beyond the end of Phase II: these are matters of timing and the practical politics of the policy and legislative process.

So far as the specifics of any legislative ‘package deal’ are concerned, one model might be suggested that would tie up the loose ends, provide legal certainty under the current regime and allow amendments in allocation to be made going forward (whether for Phase II (if adopted in time) or beyond Phase II). This approach would involve the adoption of two legal instruments:

- first, a Regulation, which would immunise NAPs and the free allocation of allowances from possible challenges under EC State aids law, acting as a kind of block exemption from the prohibition on granting such aid and dating from the original grant of such allowances (whether for those already allocated under Phase I or, going forward, if a similar situation arises under Phase II allocation). This would avoid the uncertainty associated with possible challenges to NAPs in national courts (as discussed in para. 4.1.2, above);

- second, a new Directive or Regulation, amending the EU ETS to introduce different allocation mechanisms designed to avoid the pass-through problem (such as some use of auctioning or instead providing for free allocation to consumers).

The merit of this package deal would be to provide reassurance to operators under the current regime, while permitting the design of a transition from the old allocation arrangements to the new system as introduced under the new Directive.

5. Conclusions

This paper has sought to assess the extent to which the EC legal rules on State aid affect the operation of the EU ETS and the actions of Member

States under that regime. It has been shown that there is a strong series of arguments in support of the view that the free allocation of allowances under the various NAPs involves an element of State aid, which has neither been formally notified to, nor cleared by, the Commission under the EC Treaty. Even if it is found properly to have been notified, there are serious doubts as to whether the extent of aid granted satisfies the proportionality principle. As a result, the operation of the EU ETS may be subject to some legal uncertainty with regard to possible legal challenges to the current allocation of allowances. Going forward, any proposals to amend the operation of the EU ETS must take into account similar State aid considerations (particularly proportionality) and the experience gained from the working of the EU ETS in the first phase up to 2008. The structural outline of a possible legislative package has been suggested, which could achieve the safeguarding of commercial and legal certainty under the current allocation regime, while at the same time providing a basis for amendment of the allocation mechanism under the EU ETS for Phase II or beyond. The EC State aids law issue is a serious one and it needs to be taken into account by the Commission, the Member States and private parties in their future actions in this area.

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Endnotes

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1. Directive 2003/87/EC (establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC) [2003] OJ L275/32.

2. In the EC Treaty itself, there are both automatic and discretionary exceptions from the prohibition, although both require Commission approval after notification of the aid by the Member State. Under the Treaty, legislation has been adopted to exempt various aids from the prohibition, in the style of the Block Exemptions used to give effect to the exemption in Article 81(3) EC. See Joined Cases T-447/93 and T-448/93 *AITEC* v. *Commission* [1995] ECR II-1971.

3. Case C-256/97 *Déménagements-Manutention Transport SA (DMT)* [1999] ECR I-3913: has "the recipient undertaking receive[d] an economic advantage which would not have obtained under normal market conditions"?

4. See, e.g., Joined Cases 67, 69 and 70/85 *Kwekerij Gebroeders Van der Kooy* v. *Commission* [1988] ECR 219.

5. See, e.g., Case 730/79 *Philip Morris Holland B.V.* v. *Commission* [1980] ECR 2671 and Cases 296 and 381/82 *Netherlands and Leeuwarder Papierwarenfabriek* v. *Commission* [1980] ECR 809.

6. Favourable treatment granted to a given sector within the scope of general taxation will normally be regarded as an aid (Case 70/72 *Commission* v. *Germany* [1973] ECR 813) but may also be sometimes objectively justified as a response to market forces (Case 67/85 *Van der Kooy* [1988] ECR 219, although that justification was not established in the case itself).

7. See, e.g., Case 102/87 *France* v. *Commission* (*Brewery loan*) [1988] ECR 4067. This criterion is generally very easily found to be satisfied – indeed, such an effect is often assumed if the other criteria are met.

8. See also the EU ETS Directive, Recital 23 ('without prejudice to Articles 87 and 88' EC) and Para. 5 of its Annex III.

9. See also the Commission's Decision of 29 March 2000 (N653/1999) on Danish CO2 quotas in the electricity sector (summarised in the Commission's Press Release IP/00/304, which is itself available on the internet at the following web address: http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/00/304&format=HTML&aged=0&language=EN&guiLanguage=en and briefly discussed in (2000) EC Competition Policy Newsletter, No. 2, pp. 63-64). For discussion of the UK scheme see, e.g., Park, 2002. Although *cf.* the Commission's Decision of 25 July 2001, *Belgian Green Electricity Certificates* (Case N550/2000) [2001] OJ C330/3, in which the grant of 'green certificates' was held not to involve the transfer of State resources, since it amounted merely to an official proof of the fact that the relevant electricity had been produced from renewable energy sources. Similarly, the obligation to purchase a specified quantity of such certificates was held to be analogous to the purchasing. (Available on the internet (in French) at http://www.europa.eu.int/comm/secretariat_general/sgb/state_aids/comp-2000/n550-00_fr.pdf.) See, further, Merola and Crichlow, 2004, at 33-34.

10. Commission Decision of 28 November 2001 (COM(2001) 3739 final), 'State aid No. N416/2001 – United Kingdom Emission Trading Scheme' (available on the internet at: http://www.europa.eu.int/comm/secretariat_general/sgb/state_aids/comp-2001/n416-01.pdf), p. 9, para. V1(b).

11. Decision of 7 July 2004 (COM(2004) 2515/4 final), available on the internet at: http://europa.eu.int/comm/environment/climat/pdf/uk_final_en.pdf.

12. *Ibid*. This formulation is common to the majority of the Commission's Decisions on the various NAPs submitted to it for approval under the EU ETS Directive.

13. Available at http://europa.eu.int/comm/environment/climat/pdf/030401nonpaper.pdf.

14. Decision of 20 October 2004 (COM(2004) 3982/7 final), available on the internet at: http://europa.eu.int/comm/environment/climat/pdf/france_final_en.pdf.

15. *Ibid*., Articles 2 and 3 of the Commission's formal Decision.

16. See the EU ETS Directive, Recital 23 ('without prejudice to Articles 87 and 88' EC), Article 11(3) and Para. 5 of its Annex III. Indeed, it seems unlikely that the relevant provision in the EC Treaty (Article 175(1) EC, which conferred power upon the EC to adopt environmental legislation such as the EU ETS Directive) would allow the adoption of any wholesale exemption that would not be compatible with the provisions on State aids.

17. See the Commission Guidelines [2001] OJ C37/3, esp. para. 14ff.

18. *Ibid.*, para. 18.

19. *Ibid.*, para. 19.

20. *Ibid.*, paras. 72-73.

21. Note that there will not be a common European interest in a scheme, "unless it forms part of a transnational European programme supported jointly by a number of Governments of the Member States, or arises from concerted action by a number of Member States to combat a common threat such as environmental pollution" (Joined

Cases 62 and 72/87 *Executif regional wallon and S.A. Glaverbel* v. *Commission* [1988] ECR 1573).

22. Merola and Crichlow, 2004, at 47.

23. Commission Guidelines [2001] OJ C37/3, para. 32.

24. See, e.g., the Commission's subsequent Decision on the UK's own national ETS, prior to the EC Directive, discussed above (see n. 9 and the accompanying text).

25. Discussed in para. 2.2, above.

26. See, e.g., Case C-331/88 *R.* v. *Minister of Agriculture, Fisheries and Food and Secretary of State for Health* ex p. *Fedesa* [1990] ECR 4023, Tridimas, 1998, chs. 3 and 4 and (generally) Ellis (ed.), 1999.

27. See Case 730/79 *Philip Morris Holland B.V.* v. *Commission* [1980] ECR 2671, para. 17, where the ECJ made clear that the aid must be necessary for the achievement of the relevant objectives. As others (Merola & Crichlow, 2004) have noted, "[t]his criterion also means that all the aspects of the aid, and in particular the amount of the aid, must be reduced to a minimum. In addition, the duration, intensity and scope of the aid must be proportiona[te] to the intended objective". See, also, the Commission's Decision in the matter that led to the *Van der Kooy* case (Decision 85/215/EEC on the preferential tariff charged to glasshouse growers for natural gas in the Netherlands, [1985] OJ L97/49 (for the ECJ's judgment on the appeal, see n. 4, above)), in which it was considered whether or not the aid was objectively justified in providing support to the horticultural purchasers to prevent them from switching to use coal as their energy source instead of natural gas. See also the *Chronopost* judgment (Cases C-83, 93 and 94/01 P *Chronopost S.A.* v. *Commission* [2003] ECR I-6993), where the 'market economy investor principle' usually applied in determining the notion of an 'advantage' was (in context) changed from the

question of an investment in normal market conditions to the costs borne by another *public* company (paras. 33-41) – this, too, could be argued to approximate to something of a proportionality criterion in that it allows a margin to the Member State in assessing what amounts to granting an 'advantage' to the recipient undertaking, dictated by the specific context in which the alleged aid was granted. See also Van Calster (Van Calster, 2000, at 299), who asserts that "[t]he principle of proportionality plays an important role throughout the [Commission's] guidelines [on State aid for environmental purposes]" (although he was here referring to the previous 1994 incarnation of the guidelines on State aid for environmental protection there is nothing in the subsequent 2001 guidelines to suggest any change in his assessment of the significance of proportionality throughout the guidelines).

28. For an analogous point in EC antitrust law relating to anti-competitive agreements, see Case T-374/94 *European Night Services Ltd.* v. *Commission* [1998] ECR II-3141, para. 102: just as the fact that the parties' market share may exceed the Commission's *de minimis* threshold does not necessarily make any restriction of competition an 'appreciable' one under Article 81(1) EC, it is also possible that an agreement might fall below that threshold and yet still have an appreciable effect upon competition.

29. Ismer and Neuhoff, 2004.

30. See n. 14, above, and the accompanying text: the point is the fear that excessive allocation to the industrial sector might be thought to favour that sector selectively, without the need for them to bear a concomitant environmental burden.

31. As one could argue that it currently is, given its specification of "installations" as the only possible recipients of allowances, plus the detailed provisions in Annexes I and III of the EU ETS Directive. On the issue of harmonisation, see generally Slot, 1996 and Dougan, 2000.

32. E.g., in Case 264/82 *Timex Corp.* v. *Council and Commission* [1985] ECR 849, the applicant sought the imposition of a higher level of anti-dumping duty imposed against the imports – pending a fresh decision, the old duty remained in force.

33. Case C-295/90 *European Parliament* v. *Council* (‘*Student rights of residence*’) [1992] ECR I-4193.

34. Evans, 1997, at 458 and the cases cited therein. See also, generally, Struys and Abbott, 2003.

35. See Case C-44/93 *Namur-Les Assurances de Crédit* v. *OND* [1994] ECR I-3829 and Case C-99/98 *Austria* v. *Commission* [2001] ECR I-1101.

36. See Case 52/84 *Commission* v. *Belgium* [1986] ECR 89.

37. See Joined Cases 205-215/82 *Deutsche Milchkontor GmbH* v. *Germany* [1983] ECR 2633.

38. On QMV, see (e.g.) Dashwood and Johnston, 2004, esp. 1493-1500 and 1513-1516.

39. [1999] OJ 184/23.

40. As evinced by the Commission’s document providing ‘Replies to some frequently asked questions on the EC emissions trading proposal’ (23 April 2002): available on the web at: http://europa.eu.int/comm/environment/climat/pdf/emissions_faq.pdf.

41. One solution to that Member State implementation problem would be the adoption of an EC Regulation (rather than a Directive), since this would apply in all Member States from its entry into force without the need for further legal implementation measures to be adopted by the Member States. The relevant legal basis for such action, Article 175(1) EC,

permits the adoption of “measures”, which means that both Directives and Regulations may be adopted by the Council and the European Parliament, acting as co-legislators. On the one hand, given the concerns expressed in some quarters about the inconsistencies between allocation methods adopted under the NAPs of different Member States (see, e.g., section 3.3.2.2, above), this method would have the additional benefit of setting uniform EC allocation rules (rather than the guiding principles in the current Annexes to the EU ETS Directive). On the other hand, securing agreement on such a Regulation may complicate the legislative process still further, causing delays and political compromises that may not be as much of an improvement over the current situation as one might hope. Also, justifying a far-reaching legislative measure such as a Regulation will require strong arguments for such action on the EC level according to the principle of subsidiarity under Article 5 EC.