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EU Emissions Trading

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Published in:
Research Handbook on EU Environmental Law

IMPORTANT NOTE: You are advised to consult the publisher's version (publisher's PDF) if you wish to cite from it. Please check the document version below.

Document Version
Publisher's PDF, also known as Version of record

Publication date:
2020

[Link to publication in University of Groningen/UMCG research database](#)

Citation for published version (APA):

Weishaar, S. (2020). EU Emissions Trading: Its Regulatory Evolution and the Role of the Court. In M. Peeters, & M. Elia Antonio (Eds.), *Research Handbook on EU Environmental Law* (pp. 443-457). (Research Handbooks in European Law series). Edward Elgar.

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28. EU Emissions Trading – Its Regulatory Evolution and the Role of the Court

Stefan E. Weishaar

1. INTRODUCTION

Over time the regulatory framework of the EU ETS has become tremendously complex and detailed. This chapter reviews the important shift of governance within the EU ETS from a decentralized approach with allocation competences for the Member States to a centralized approach with harmonized allocation criteria, and examines which role climate litigation has played in shaping the EU ETS's development. It does so by reviewing the wider context of the EU ETS, including the influence of economic developments on the functioning of the EU ETS, by examining the most important legislative changes and the cases that arose before the CJEU.

The chapter first presents the economic rationale of emissions trading as a regulatory instrument, before reviewing the development of and experience with EU ETS legislation (sections 2 and 3). In section 4 it examines the case law and the role of the CJEU in shaping the EU ETS system. Section 5 concludes.

2. BACKGROUND: CAPTURING THE ECONOMIC RATIONALE OF EMISSIONS TRADING IN A REGULATORY INSTRUMENT

Emissions trading was first recommended by Crocker in 1966 and described in more detail by Dales in 1968. It was for the first time successfully applied in the American SO_x trading system and the NO_x trading system which were established in the 90s of the twentieth century.¹ Meanwhile, it had long been discussed in the European context.²

When determining which instruments to use to fight climate change, the legislator has the choice between inter alia command and control types of regulation and market-based instruments, such as taxation or emissions trading. Emissions trading has a number of appealing attributes. It can be designed with an emissions cap so that the environmental target is achieved with only the price of allowances being uncertain (and

¹ See for instance Dallas Burtraw, Sarah Jo Szambelan, *U.S. Emissions Trading Markets for SO₂ and NO_x*, Discussion paper (Resources for the Future October 2009).

² T.D. Crocker, 'The Structuring of Atmospheric Pollution Control Systems' in H. Wolozin (ed.), *The Economics of Air Pollution* (Norton 1966) 61–86; J.H. Dales, *Pollution, Property & Prices*, (University of Toronto Press 1968, reprinted 1975); M. Peeters, 'Towards a European Market for Tradable Pollution Permits?' (1993) *Tilburg Foreign Law Review*, 2, 117–34.

hence the price automatically adjusts for inflation). An ETS works as an automatic stabilizer, increasing the costs of covered entities if the economy is overheating and mitigating the environmental cost burden if it is contracting. The most appealing element of an ETS is that it allows covered entities to determine themselves who will abate emissions and who will purchase emission allowances, freeing the legislator from having to gather too much information on operators' cost functions. The initial cost estimates of the EU ETS were between 2.9 and 3.7 billion Euros while other instruments would have at least cost 6.8 billion Euros, hence giving rise to a very substantial cost saving.³

3. DEVELOPMENT OF AND EXPERIENCE WITH THE EU ETS LEGISLATION

The World Conference on the Changing Atmosphere held in Toronto 1988 called for sharp cuts in carbon dioxide emissions and has sparked international awareness and legislative action – both in EU Member States and at EU level.⁴ Starting in 1991, the European Commission has taken measures to reduce greenhouse gas emissions and to improve energy efficiency.

The European Commission's first choice to address climate change was to introduce a tax. In 1992, it proposed a tax on carbon dioxide emissions and energy that Member States had to introduce for various forms of energy.⁵ The tax rates were envisaged to rise over time and the proposal included derogations for renewable energy and energy intensive sectors. Since the measure required unanimity⁶ that could not be reached by the Member States, the measure was not adopted.⁷ A few years later, the Commission tried again. In 1995, it proposed an amendment of its earlier tax proposal addressing some of the contentious issues and affording Member States the possibility to set tax rates more

³ European Commission 'EU emissions trading: an open scheme promoting global innovation to combat climate change' (2005) 8. The environmental effectiveness of the EU ETS is safeguarded by the overall emissions cap, under the assumption of full compliance by covered entities. This chapter will not delve into the compliance issue which given its importance deserves separate in-depth attention. On the experience of the EU ETS in the first trading phase see D. Ellerman and B. Buchner 'Over-allocation or Abatement? A Preliminary Analysis of the EU ETS Based on the 2005–06 Emissions Data' (2008) *Environ. Resource Econ.*, 41, 267–87.

⁴ Environmental tax shifts and the introduction of the carbon tax in Finland, Denmark and Sweden have been facilitated by this heightened public awareness. See S.E. Weishaar, 'Fault Lines Between Fees and Taxes: Legal Obstacles for Linking', in L. Kreiser, M. Skou Andersen, B. Egelund Olsen, S. Speck, J.E. Milne and H. Ashiabor (eds), *Carbon Pricing – Design, Experience and Issues*, Critical Issues in Environmental Taxation Volume XV, (Edward Elgar 2015) 32–45. 91/565/EEC: Council Decision of 29 October 1991 concerning the promotion of energy efficiency in the Community (SAVE programme). OJ L 307, 8.11.1991.

⁵ Proposal for a Council Directive Introducing a tax on carbon dioxide and energy. COM (92) 226 final, 30 June 1992.

⁶ The legal base was Article 130s EC Treaty (now Article 192 TFEU) which at that time did not yet distinguish between fiscal and non-fiscal measures and required unanimity.

⁷ S.E. Weishaar, 'Carbon Taxes in the EU – Introduction, Challenges and Barriers', (2018) *Zeitschrift für Europäisches Umwelt- und Planungsrecht* 16(3), 289–96.

freely. The long-term tax trajectory was also watered down to a non-binding target.⁸ Again the proposal failed to meet the unanimity requirement.

In the run-up to the Nice Treaty and EU enlargement, the Commission attempted to introduce qualified majority voting for environmental taxes and issued a Communication to this effect.⁹ This was also not embraced by the Member States.¹⁰ Despite the setbacks related to taxation, the Commission continued to strive to address climate change and embraced emissions trading instead.¹¹

Following the EC's accession to the United Nations Framework Convention on Climate Change (UNFCCC)¹² the European Community sought to realize commitments made under the Kyoto Protocol of attaining an average annual emission reduction of 8 per cent below 1990 levels during the period of 2008–2012. The European Climate Change Programme (ECCP)¹³ was launched in 2000 to enable the EU to cost-effectively meet the Kyoto Protocol target and to complement the efforts of the Member States to realize their climate goals and to make progress towards realizing their commitments under the Burden Sharing Agreement.¹⁴ After detailed considerations,¹⁵ the Commission proposed several measures including the ratification of the Kyoto Protocol,¹⁶ the regulation of fluorinated gases,¹⁷ the establishment of the EU ETS,¹⁸ and the linking of the EU ETS to the Kyoto Protocol offsets.¹⁹ The latter two developed into the EU ETS Directive (Directive 2003/87/EC)²⁰ and the Linking Directive (2004/101/EC).²¹

The first EU ETS trading period commenced on 1 January 2005 and extended to

⁸ Amended proposal for a Council Directive introducing a tax on carbon dioxide and energy. COM (95) 172 final, 10 May 1995.

⁹ COM (2000) 114 final.

¹⁰ S.E. Weishaar, 'Introducing Carbon Taxes – Issues and Barriers', in M. Hymel, L. Kreiser, J.E. Milne and H. Ashiabor (eds), *Critical Issues in Environmental Taxation*, Vol.20, (Edward Elgar 2018) 3–19.

¹¹ For a comparison on the efficiency of taxation and other instruments including emissions trading see M.G. Faure and S.E. Weishaar, 'The Role of Environmental Taxation: Economics and the Law', in J.E. Milne, and M. Skou Anderson (eds), *Handbook of Research on Environmental Taxation*, (Edward Elgar 2012) 399–421.

¹² Council Decision 94/69/EC of 1993.

¹³ COM (2000) 88.

¹⁴ This agreement redistributed the Kyoto Protocol reduction obligations of the Member States among each other (Cyprus and Malta did not assume reduction obligations). See Document 9702/98 of 19 June 1998 from the Council of the European Union reflecting the outcome of proceedings of the Environment Council of 16–17 June 1998 and COM(98) 353 final, COM(99) 230 final.

¹⁵ ECCP (2001).

¹⁶ COM (2001) 579 final.

¹⁷ COM (2003) 492 final.

¹⁸ COM (2001) 581 final. This later gave way to Directive 2003/87/EC.

¹⁹ COM (2001) 580 final. A carbon offset is a greenhouse gas emission reduction made in order to compensate for emissions made elsewhere.

²⁰ Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC, OJ L 275, 25.10.2003, 32–46.

²¹ Directive 2004/101/EC of the European Parliament and of the Council of 27 October 2004 amending Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the Community, in respect of the Kyoto Protocol's project mechanisms OJ L 338, 13.11.2004, 18–23

around 12,000 installations of approximately 5,000 operators in all EU Member States. These installations belong to four broad sectors: energy (electric power, oil refineries, etc.), the production and processing of ferrous metals (iron and steel), minerals (cement, glass ceramics), pulp and paper. A few years later also aviation was added.²² The EU ETS extends over several trading phases. The first lasted from 2005–2007, the second from 2008–2012, the third extends from 2013–2020 and the fourth will last from 2021–2030.

The first trading period was a ‘learning by doing’ phase,²³ because the system was implemented in a very short period of time. There was a significant amount of over allocation and this contributed to low allowance prices.²⁴ When the EU ETS was launched in 2005, the allowance prices swiftly approached 27 Euros and hence came into the realm of prices envisaged by the European Commission. Prices halved in May 2006 when verified emissions turned out lower than expected. By October 2006, it had become apparent that there was over-allocation and allowances fell to 0.10 Euro.

The over-allocation problem was addressed in the second trading phase once adequate emission data was available from the installations and it had become apparent that Member States had been too generous when drafting their National Allocation Plans (NAPs) and in allocating emission allowances.²⁵ Recalibrating the NAPs for phase 2 was, however, not without conflict, since Member States attempted to resist the Commission’s ambition to correct their NAPs and thus to determine their emissions in the covered sectors. This led to more market uncertainty and unstable carbon prices.²⁶ Meanwhile, during the phase 2 and despite undue interference of the European Commission in the NAP drafting process, the allocation process has largely stayed the same with the only difference that Member States were allowed to auction up to 10 per cent of their allowances in phase 2, as was envisaged by the EU ETS Directive.²⁷

An important problem that arose during phase 2 was the VAT fraud and theft of allowances. The VAT fraud occurred between the summers of 2008 and 2009. These fraud schemes often took the form of a missing trader in intra-community transactions where VAT is not due upon export from one Member State but should be (but is not) surrendered in the Member State where the goods are sold. This type of fraud was sizable and inflated the trading volume on the biggest European spot market by 85 per cent.²⁸ The fraud was initially

²² Directive 2008/101 of 19 November 2008 amending Directive 101 of the European Parliament and of the Council to include aviation, OJ L 8/3.

²³ COM (2000) 97 final, 10 and M. Peeters and J. De Cendra de Laragán ‘Perspectives on the Fundamental Choice Between ‘cap and trade’ and ‘credit and trade’, (2007) *European Environmental Law Review* 16, 7.

²⁴ O. Kuik and F. Oosterhuis, ‘Economic Impacts of the EU ETS: Preliminary Evidence’ in: M.G. Faure and M. Peeters (eds) *Climate Change and European Emissions Trading: Lessons for Theory and Practice* (Edward Elgar 2008) 208–24, especially 217.

²⁵ D. Ellerman and B. Buchner (2008) o.c. 272ff.

²⁶ J. Van Zeven ‘Implementation Challenges for Emission Trading Schemes: The Role of Litigation’, in S.E. Weishaar (eds) *Research Handbook on Emissions Trading* (Edward Elgar 2016) 249.

²⁷ Article 10 of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowances trading within the Community OJ L 275/32 of 25.10.2003.

²⁸ K. Nield and R. Pereira ‘Fraud on the European Union Emissions Trading Scheme: effects, vulnerabilities and regulatory reform’, (2011) *European Energy and Environmental Law Review* 20(6) 255–89.

addressed by revising the VAT Directive so as to allow Member States to employ a reverse charging mechanism for domestic sales of allowances.²⁹ The VAT treatment was harmonized by defining emission allowances as financial instruments under the revised Markets in Financial Instruments Directive (MiFID II)³⁰ entailing that no VAT would be due.³¹

Starting in January 2010, phishing attacks were on their way. Fraudsters posing as registry administrators obtained ETS account details and stole allowances in Germany, Romania, Italy, Austria, The Czech Republic and Greece. Even though the rules on allowance registries were standardized and based upon regulations,³² the safeguards for allowances differed, because the minimum access requirement that entered into force in October 2010 (and applied as of 1 January 2012) had not yet been implemented by several Member States.³³ Ultimately, the entire EU ETS trade was suspended on 19 January 2011, until Member States could prove to the Commission that they had minimum safeguards in place. Subsequently, the decentralized registry system was brought into a single central Union Registry.³⁴

At the beginning of phase 2 in 2008, allowance prices rose initially to around 30 Euros. Prices were, however, falling again as a result of the global economic crisis, which led to a prolonged excess supply situation.^{35, 36} Allowance prices remained low (between 5 and 7 Euros for many years and only were to rise again in the third trading phase (discussed below). Unsurprisingly, addressing the surplus (oversupply) situation received much attention during phase 2 (2008–2012), but, as was to be expected, the adoption of legislative measures took several years and came too late to have a meaningful effect in the third trading phase (2013–2020).

Only a few years after the EU ETS entered into force, the system was fundamentally overhauled by Directive 2009/29/EC.³⁷ This Directive changed the EU ETS from a

²⁹ Article 1 of Council Directive 2010/23/EU and Council Directive 2013/43/EU.

³⁰ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014, L 173/349.

³¹ See Council Directive 2006/112 of 28 November 2010, OJ L 347, 11.12.2006, 1–118.

³² Commission Regulation 2216/2004 of 21 December 2004 for a standardised and secured system of registries pursuant to Directive 2003/87/EC of the European Parliament and of the Council and Decision No 280/2004/EC of the European Parliament and of the Council and Decision No 280/2004 of the European Parliament as amended by Commission Regulation 994/2008 of 8 October 2008.

³³ K. Nield and R. Pereira, 'Financial Crimes in the European Carbon Markets' in Weishaar (2016) o.c. 209 ff.

³⁴ Commission Regulation (EU) No 389/2013 of 2 May 2013 establishing a Union Registry pursuant to Directive 2003/87/EC of the European Parliament and of the Council, Decisions No 280/2004/EC and No 406/2009/EC of the European Parliament and of the Council and repealing Commission Regulations (EU) No 920/2010 and No 1193/2011, OJ L 122, 3.5.2013, p. 1–59.

³⁵ C. Kettner, 'The EU Emission Trading Scheme: First Evidence on Phase 3', in Kreiser, et al (2015) o.c. 63–75.

³⁶ This text distinguishes between over-allocation and surplus (over supply). The former denotes a situation where more allowances than were needed were allocated to market participants. The latter describes a situation where there are too many allowances available on the market and hence allowance prices are low.

³⁷ Directive 2009/29/EC of the European Parliament and of the Council of 23 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community OJ L 140, 5.6.2009, 63–87.

decentralized allocation format based National Allocation Plans to a centralized allocation format.³⁸ These changes took effect in the third trading phase and brought the Commission clearly into the driving seat.³⁹

Harmonized auctions are now the default allocation for the power sector. Auctions are also increasingly phased in for other sectors, starting at 20 per cent and increasing to 70 per cent in 2020; 50 per cent of the auction revenues should be spent on climate change related issues. The remainder of the allowances is still allocated for free.

The number of free allowances to be allocated to installations is according to Directive 2009/29/EC a product of several factors: benchmarks, historic activity levels, carbon leakage exposure factor, and a cross-sectoral correction factor or linear factor.⁴⁰ Benchmarks are based on the top 10 per cent most efficient installations during the years 2007 and 2008 and set for the trading period.⁴¹ The linear reduction factor – that lowers the total amount of greenhouse gas emissions regulated by the EU ETS (in short, the cap) – constitutes a 1.74 per cent annual reduction of the overall amount of allowances that are available.⁴²

The EU ETS did not have systemic safeguards to counter the surplus (oversupply) situation which resulted from the economic downturn in 2008/2009, the increased use of offsets as well as the sale of allowances contained in the new entry reserve. Due to the possibility of banking between the trading phases, the excess supply remained a problem also for the third trading phase (2013–2020). Prices fell to around 3.50 Euros in 2013 and were deemed too low to stimulate technological innovation – one of the objectives enlisted in the recitals of the EU ETS Directive.

The surplus (oversupply) of EU ETS emission allowances has probably various causes. First and foremost, it is attributable to the contraction of the European economy in 2008/2009 and slow economic growth and hence a decline in the demand for emission allowances. Yet, additional sources of emission allowances exacerbated the situations. These additional allowances came from:

- the sale of emission allowances contained in national new entrance reserves (around 100 million);
- the sale of emission allowances from the NER 300 (200 million in 2012 and 100

³⁸ Article 9 was amended by Directive 2009/29/EC so national allocation plans did not have to be drawn up anymore.

³⁹ See Directive 2009/29/EC, Commission Decision of 27 April 2011 determining transitional Union-wide rules for harmonised free allocation, 2011/278/EU and 2013/448/EU; Commission Decision of 5 September 2013 concerning national implementation measures for the transitional free allocation of greenhouse gas emission allowances in accordance with Article 11(3) of Directive 2003/87/EC of the European Parliament and of the Council OJ L 240, 7.9.2013, 27–35.

⁴⁰ The historic activity level represents the two average of two median production values during the period 2005–2008 or 2009–2010. See Article 10a(1) of Directive 2009/29/EC and Article 9(1) of 2011/278/EU; Commission Decision of 27 April 2011 determining transitional Union-wide rules for harmonised free allocation of emission allowances pursuant to Article 10a of Directive 2003/87/EC of the European Parliament and of the Council (notified under document C(2011) 2772) OJ L 130, 17.5.2011, 1–45.

⁴¹ Article 10a(2) Directive 2009/29/EC.

⁴² *Ibid.*, Article 9.

million in 2013) program run by the European Investment Bank to incentivize Carbon Capture and Storage;

- early auction of 2013 emission allowances to facilitate the transition to the third trading phase and to mitigate allowance price increases due to hedging demand (120 million allowances);
- offsets from Clean Development Projects (CDM).⁴³

Only relatively few offsets were used in the first trading period in the EU ETS, but imports rose quickly in phase 2. The Commission has responded to limit the sources from which offsets can be derived. These more stringent rules exclude offsets from HFC-23 reduction projects and N₂O decomposition projects.⁴⁴ They are expected to reduce the availability of CERs.⁴⁵

The cumulative surplus (oversupply) of EU ETS allowances at the end of phase 2 (2008–2012) is estimated to be around 1,826 million allowances. This suggests a surplus (oversupply) of around 19 per cent above the total actual emissions in the second trading phase.⁴⁶ In terms of the third trading phase (2013–2020) this amounts to around 12 per cent.⁴⁷

Because banking was allowed during the second and third trading phase of the EU ETS, it is expected that the surplus (oversupply) will persist beyond 2020,⁴⁸ thus well into the fourth trading period, implying that no additional reduction efforts are required in the third trading period.⁴⁹ Banking is also the reason why allowance price levels in phase 2 did not fall to 10 euro cents (as in phase 1) but why prices often remained between 4 and 5 Euros. Also projections for allowance market prices in the third trading phase were deemed too low to incentivize investment in abatement technology and innovation.⁵⁰

⁴³ EC Commission Staff Working Document SWD(2012) 234 final of 25.7.2012.

⁴⁴ See Commission Regulation 550/2011 of 7 June 2011 on determining, pursuant to Directive 2003/87/EC of the European Parliament and of the Council, certain restrictions applicable to the use of international credits from projects involving industrial gases, OJ L 149/1 of 08/06/2011.

⁴⁵ Around 80% of the CDM credits that were surrendered in 2010 are banned as of 1 May 2013. See SWD(2012) 234 final of 25.7.2012 and Commission Regulation 550/2011.

⁴⁶ According to Commission data the total number of verified emissions in the second trading phase was 9,651 million tons of CO₂ equivalents (assuming that the numbers for 2012 are the same as for 2011) while total supply was 11,477 million tons of CO₂ equivalents (assuming that the number of offsets used for compliance in 2012 was the same as for 2011) (See SWD(2012) 234 final of 25.7.2012). Dividing total supply by total verified emissions and subtracting 1 yields a surplus (oversupply) of 18.92%.

⁴⁷ The estimated total amount of emission allowances that will be available during the third trading period is 15775 million tons. $1826/15775 = 11.57\%$.

⁴⁸ PBL 'Evaluation of policy options to reform the EU Emissions Trading System Effects on carbon price, emissions and the economy' (2013) available at: <http://www.pbl.nl/publicaties/evaluatie-van-opties-om-het-europese-emissiehandelssysteem-te-hervormen>, 30, accessed 5 April 2019.

⁴⁹ See on this C. Egenhofer, A. Marcu and A. Georgiev, 'Reviewing the EU ETS Review' (2012). Available from: <https://www.ceps.eu/ceps-publications/reviewing-eu-ets-review/> viewed 5 April 2019 and PBL (2013) 29.

⁵⁰ See Commission Staff working document, proportionate impact assessment (2012) 22–3 and PBL (2013) 30.

Against this backdrop, the Commission is pursuing a three-pronged approach to address the mismatch between supply and demand in the EU ETS:

- (1) it sought clarification on the legal right of the European Commission to change the timing of auctioning allowances.⁵¹ This is commonly referred to as the ‘backloading’ decision. With the amendment of Article 10(4) of Directive 2003/87/EC, the Commission is allowed to adapt the auction timetable once to backload up to 900 million allowances in exceptional circumstances to ensure the orderly functioning of the market.⁵²
- (2) the Commission proposed to amend the auctioning regulation (Commission Regulation 1031/2010)⁵³ in order to time-shift the auctioning of 400, 300 and 200 million allowances in the years 2014–2016 respectively. These allowances will be auctioned off in 2019 (300 million) and 2020 (600 million) allowances.⁵⁴
- (3) the Commission has been reviewing structural reforms for the EU ETS to address surplus (oversupply). The Commission invited responses to its report on the state of the European carbon market⁵⁵ in which it proposed structural reform options, and held a consultation round and two stakeholder meetings on structural options to strengthen the EU Emissions Trading System.

The Commission ultimately proposed to increase the annual reduction factor to 2.2 per cent⁵⁶ and to introduce a market stability reserve as of 2021.⁵⁷ Both elements were adopted in the reform process for the fourth trading period which resulted in Directive

⁵¹ COM (2012) 416, Proposal for a Decision of the European Parliament and of the Council amending Directive 2003/87/EC clarifying provisions on the timing of auctions of greenhouse gas allowances, 2012/0202/COD.

⁵² European Parliament legislative resolution of 10 December 2013 on the proposal for a decision of the European Parliament and of the Council amending Directive 2003/87/EC clarifying provisions on the timing of auctions of greenhouse gas allowances (COM(2012)0416 – C7-0203/2012 – 2012/0202(COD)) available at <http://www.europarl.europa.eu/sides/getDoc.do?typ e=TA&language=EN&reference=P7-TA-2013-0543#BKMD-44> viewed on 18.12.2013.

⁵³ Commission Regulation (EU) No 1031/2010 of 12 November 2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances pursuant to Directive 2003/87/EC of the European Parliament and of the Council establishing a scheme for greenhouse gas emission allowances trading within the Community, OJ L 302, 18.11.2010, 1–41.

⁵⁴ See http://ec.europa.eu/clima/policies/ets/reform/docs/com_2014_xxx_en.pdf, accessed 5 April 2019. And Commission Regulation (EU) No 176/2014 of 25 February 2014 amending Regulation (EU) No 1031/2010 in particular to determine the volumes of greenhouse gas emission allowances to be auctioned in 2013–20 Text with EEA relevance OJ L 56, 26.2.2014, 11–13.

⁵⁵ COM(2012) 652 final.

⁵⁶ COM(2014) 15 final, Communication from the Commission to the European Parliament, The Council, The European Economic and Social Committee and the Committee of the Regions, A policy framework for climate and energy in the period from 2020 to 2030.

⁵⁷ COM(2014) 20/2, Proposal for a Decision of the European Parliament and of the Council concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC. Decision (EU) 2015/1814 of the European Parliament and of the Council of 6 October 2015 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC (OJ L 264, 9.10.2015, 1).

2018/410.⁵⁸ Trading phase 4 will last from 2021 till 2030, and will have a sharpened emissions reduction goal of -43 per cent below 2005 levels.⁵⁹

The market stability reserve is a mechanism that actively reduces the surplus (excess supply). Whenever the overall number of allowances on the market (European Allowance Units and Offsets) exceeds 833 million tons, 12 per cent of the allowances on the market are brought into this reserve. These allowances are released in batches of 100 million allowances once the excess supply is reduced to 400 million allowances. This quantity mechanism is intended to prevent structural surplus (oversupply) situations.

Directive 2018/410 substantially strengthened the Market Stability Reserve (MSR)⁶⁰ by temporarily doubling the feed-in rate of allowances into the MSR to 24 per cent between 2019 and until 31 December 2023.⁶¹ Especially important is that from 2023 onwards the amount of allowances that can be held in the MSR will be restricted to the auction volume of the preceding year while the remainder of allowances will be cancelled.⁶² This avoids that a large stock of allowances will be rolled over for prolonged periods of time and help to support allowance prices.

At least 57 per cent of all allowances will be auctioned in phase 4 while sectors facing the highest risk of carbon leakage will be fully allocated for free.⁶³ For less exposed sectors, free allocation is foreseen to be reduced linearly from 30 per cent in 2026 and shall be completely phased out by 2030.⁶⁴ Moreover, free allowances are reserved for new entrants.⁶⁵

Importantly, in phase 4 there is a strong focus on aligning production with allocation. The allocations to installations can be adjusted annually to reflect changes in the actual production levels (both increased and decreased production) provided that the production changes by more than 15 per cent from the two-year average compared to the initially determined allocation.⁶⁶ This is tantamount to ex-post adjustment, i.e. it constitutes a redistribution of allowances among covered entities. Also, the list of installations eligible for free allocation and the benchmarks for free allocation will be updated twice during phase 4.⁶⁷

Furthermore, low-carbon innovation and energy sector modernization is supported by two new funds: the innovation fund that will extend the existing NER 300 fund and the

⁵⁸ Directive (EU) 2018/410 of the European Parliament and of the Council of 14 March 2018 amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, and Decision (EU) 2015/1814, OJ L 76, 19.3.2018, 3–27.

⁵⁹ This is achieved by sharpening the linear reduction factor in 2021 to -2.2% (from -1.74%) as already discussed. Member States have to reduce emissions by on average 30% below 2005 levels pursuant to Regulation 2018/842 of 30 May 2018 (OJ L 156, 26, 19.6.2018) in non-ETS sectors such as transport, buildings and heat. The 2030 goals have increased markedly from the 10% goal in 2020 pursuant to Decision 406/2009/EC of 23 April 2009 (OJ L 140, 5.6.2009, 136).

⁶⁰ First established with Decision (EU) 2015/1814, above.

⁶¹ Article 2 of Directive 2018/410 of 14 March 2018.

⁶² *Ibid.*

⁶³ *Ibid.*, Article 1(13a) and 1(15).

⁶⁴ *Ibid.*, Article 1(15.4).

⁶⁵ *Ibid.*, Article 1(14g).

⁶⁶ *Ibid.*, Article 1(14m).

⁶⁷ *Ibid.*, Article 1(14b).

modernisation fund will support the power sectors and energy systems in carbon dependent regions in the ten lower-income Member States.⁶⁸

In sum, the application of the EU ETS encountered many challenges relating to allocation. Moreover, allowance prices stayed for a long time at a low level. The system was even plagued by fraud and theft. As a result of addressing these various challenges, the regulatory system for the EU ETS became very complex. The new period (2021–2030) will face an adapted legislative approach with, as a novel approach, a Market Stability Reserve Mechanism and a strengthened cap. One of the important issues for this new period could be the challenge to keep industries compliant with the obligations of the EU ETS.

4. CASE LAW

The previous section has examined the evolution of the EU ETS and pointed towards important issues and challenges that have been shaping its development. This section examines the role of the Court in shaping the EU ETS.

4.1 The First and Second Trading Periods (the Decentralized Model)

The EU ETS is a measure that strongly affects the economic position of undertakings by putting a price on greenhouse gas emissions. Several cases have been brought through an action for annulment under Article 263 TFEU by undertakings to challenge the Commission's decision to approve NAPs or to raise objections against them. In the cases, the undertakings were held not to have legal standing, because they did not fulfil the requirements provided for private applicants under Article 263 TFEU,⁶⁹ or because their situation was not impacted by the approval of the NAP as such, but only by the subsequent allocation decision of the Member States.⁷⁰ Consequentially the correct forum would be a national one.

One of the few cases that reached the Court (in a preliminary ruling procedure) was *Arcelor*⁷¹ where the scope of the EU ETS was challenged on the basis of the equal treatment principle. Arcelor objected that the steel sector was covered by the EU ETS while chemicals and non-ferrous metal industries were not covered by the ETS and hence not subject to similar measures. The Court held that the sectors were indeed comparable and treated differently, as the steel sector was put at a disadvantage vis-à-vis the other sectors. The Court, however, concluded that dissimilar treatment was justifiable on the basis of objective and reasonable criteria, and that the exclusion of these sectors was proportional as the administrative burden of their inclusion would have been too high.⁷²

In the decentralized model, most cases regarding the EU ETS emerged between the

⁶⁸ *Ibid.*, Annex IIb and Article 1(14h) and 1(16).

⁶⁹ T-13/07, *Cemex UK Cement v Commission*, ECLI:EU:T:2007:331; T-27/07, *US Steel Košice v Commission*, ECLI:EU:T:2007:302 with appeal case C-6/08 P, *US Steel Košice v Commission*, ECLI:EU:C:2008:356.

⁷⁰ T-387/04, *EnBW Energie Baden-Württemberg v Commission*, ECLI:EU:T:2007:117.

⁷¹ C-127/07, *Arcelor*, ECLI:EU:C:2008:728.

⁷² *Ibid.*, paras 65ff.

Commission and Member States. The Commission is the guardian of the Treaty and empowered by Article 258 TFEU to bring cases against Member States if they fail to correctly implement Directives. Using those powers, the Commission brought infringement proceedings against Italy for failing to adopt in time the necessary laws and provisions to comply with Directive 2003/87/EC.⁷³ Proceedings were furthermore brought against Finland for providing an exemption to the Directive for the province of Åland.⁷⁴

Furthermore, on the basis of the EU ETS Directive Member States were obliged to draft National Allocation Plans (discussed in section 3), to notify the Commission of them, and to allocate allowances to installations. Member States in particular had to observe the allocation criteria contained in Annex III of Directive 2003/87/EC. The NAPs were subject to Commission review. The German NAP for the first trading period was rejected by the Commission,⁷⁵ because the German NAP contained several *ex post* adjustment provisions that enabled Germany to reduce the number of allowances allocated to companies.⁷⁶ *Ex post* adjustments were contained in many NAPs in the first and the second trading phase and rejected by the Commission.⁷⁷ The Commission held the view that the German provisions violated two of the Annex III allocation criteria by not clearly determining which allowances accrued to which installation (Criterion 10) and the non-discrimination criterion (Criterion 5). In the application for annulment proceedings brought by Germany against the Commission, however, the Court held that the Commission erred in law in rejecting Germany's NAP, as it failed to establish that Germany's freedom to transpose the Directive was restricted by criterion 10.⁷⁸ The Court also held that regarding Criterion 5 the Commission erred in law, as it failed to show that *ex post* adjustments favours new entrants or that they would create incentives to overstate demand.⁷⁹

The case is interesting, because even though the Commission erred in law, the practical implications of the Court's decision were limited at best, as the German NAP for the second trading period had already been finalized and did not contain *ex post* adjustments.⁸⁰ The differences in the views on *ex post* adjustments between Member States and the Commission were eventually resolved by the harmonized allocation rules for trading period 3, which allows for *ex post* adjustments in the context of plant complete or partial closures.⁸¹

In infringement proceedings against the UK, the Commission's rejection of the UK's

⁷³ C-122/05, *Commission v Italy*, ECLI:EU:C:2006:336.

⁷⁴ C-107/05, *Commission v Finland*, ECLI:EU:C:2006:34.

⁷⁵ Commission Decision of 7 July 2004, C (2004) 2515/2 final.

⁷⁶ Zuteilungsgesetz 2007 of 26 August 2004 on the allocation of emission allowances during the first allocation period BGBl 2004 I, at 2211.

⁷⁷ IP/05/762 and S.E. Weishaar 'Germany v. Commission: The ECJ on Ex post adjustment under the EU ETS' (2008) *Review of European Community & International Environmental Law (RECIEL)* 17(1), 126–9.

⁷⁸ T-374/04, *Germany v Commission*, ECLI:EU:T:2007:332, para 149.

⁷⁹ *Ibid.*, paras 158–164.

⁸⁰ S.E. Weishaar 'Ex-Post-Korrektur im Europäischen CO₂-Emissionshandel: Auswirkungen der Rechtsprechung für Deutschland' (2008) *Zeitschrift für Europäisches Umwelt- und Planungsrecht*, 3, 148–51.

⁸¹ See Articles 21 and 22 of Commission Decision 2011/278/EC.

request to amend its already submitted NAP was at issue.⁸² After examining the roles of the Commission and the Member State, the Court clarified that the Commission could not restrict a Member State to propose amendments to its NAP, as the double public consultation system envisaged by the UK would otherwise have been ineffective.

Challenges against the Commission decisions also arose in the second trading period 2008–2012. These were often directed against decisions in which the Commission rejected the NAPs on the basis of suspected over-allocation of allowances.⁸³

For example, Latvia challenged the Commission for being time barred from demanding additional information on its NAP and argued that it therefore had become definitive.⁸⁴ The Court, agreeing with Latvia, reiterated its case law, stating that the Commission's discretion for substantive review of the NAPs was limited to assessing the conformity of the NAPs with the criteria in Annex III and Article 10 of the Directive, and that the Commission also had to observe the three-month time limit prescribed in the Directive.⁸⁵ The appeal brought by Commission was unsuccessful.⁸⁶

In two annulment actions brought – respectively – by Poland and Estonia, the Court clarified that the Commission acted *ultra vires* by relying upon its own data, calculation and facts and by replacing its own results for the data put forward by respective Member States in their NAPs.⁸⁷ In both situations, the Commission significantly reduced the allocations put forward by the Member States. The rejected NAPs were revised and resubmitted, rejected again and ultimately accepted and finally in place two years after the second trading phase.⁸⁸ The Court held that the Commission's right to review the NAPs was limited to questions of legality. The Commission also lost the appeal cases.⁸⁹ This group of cases shows that the Court was willing to scrutinize the Commission's exercise of discretion in the control of the NAPs.

From this analysis, it can be concluded that several of the challenges brought by Member States against the Commission in the context of initial allocation have been successful legally; however, it should also be noted that, in the end they did not have a significant impact on the regulatory approach of the EU ETS as a whole. This is because court proceedings generally took their time and the system of National Allocation Plans was abandoned in favour of harmonized allocation where the Commission was in the driving seat.

⁸² T-178/05, *United Kingdom v Commission*, ECLI:EU:T:2005:412.

⁸³ E.g. Case T-499/07, *Bulgaria v Commission* (later deleted from the Court registry), T-500/07/ *Bulgaria v Commission* (later deleted from the Court registry), Case T-483/07 *Romania v Commission* (later deleted from the Court registry), T-484/07 *Romania v Commission* (later deleted from the Court registry).

⁸⁴ T-369/07, *Latvia v Commission*, ECLI:EU:T:2011:103.

⁸⁵ Case T-387/04, *EnBW Energie Baden-Württemberg v Commission*, ECLI:EU:T:2007:117, para 104; see also, to that effect, Case T-374/04, *Germany v Commission* ECLI:EU:T:2007:332, para 116.

⁸⁶ C-267/11, *Commission v Latvia*, ECLI:EU:C:2013:624.

⁸⁷ T-183/07, *Poland v Commission*, ECLI:EU:T:2009:350 and T-263/07 *Estonia v Commission*, ECLI:EU:T:2009:351.

⁸⁸ J. Van Zeben (2016) o.c. 249.

⁸⁹ C-504/09 P, *Commission v Poland*, ECLI:EU:C:2012:178 and C-505/09 P, *Commission v Estonia*, ECLI:EU:C:2012:179.

4.2 The Centralized EU ETS Model

With the harmonized allocation format, the challenges relating to NAPs by Member States ceased. At the same time, the harmonized allocation rules⁹⁰ started to be the subject of legal challenges. In *Hüttenwerke Krupp Mannesmann and Others*, several undertakings sought the annulment of the allocation rules alleging inter alia that the criteria for setting the benchmarks had been disregarded, and wrong data had been used for calculating the benchmarks.⁹¹ The action was declared inadmissible. In *Borealis Polyolefine*, the validity of Commission Decision 2011/278/EU was again challenged in the framework of a preliminary ruling question, but upheld.⁹² However, it was also held that the Commission did not determine the uniform cross-sectoral correction factor laid down in Article 4 of Decision 2013/448 correctly; consequently, this sectoral correction factor was invalidated.⁹³

The Commission's conduct in the context of stolen allowances in the context of the fraud cases also gave rise to a legal challenge. In *Holcim (Romania)*, the applicant sought to hold the Commission liable for the market value and the interest in stolen emission allowances that were unrecoverable submitting that the Commission acted unlawfully in not allowing the disclosure of the location of stolen emission allowances.⁹⁴ The Court dismissed the action in its entirety. It therefore appears that the Court did not take an active role in the context of the ETS fraud cases.

The extension of the EU ETS to aviation through Directive 2008/101 caused a significant amount of friction between the EU and third countries such as China and the US. A case was brought by The Air Transport Association of America and two US Airlines who challenged the Directive's national implementation by the UK leading to a preliminary question on the validity and compatibility of the Directive with the Chicago Convention and the US-EU Air Transport Agreement, as well as the Kyoto Protocol and customary international law.⁹⁵ The Court held that the EU was not bound by the Chicago Convention, that it was entitled to include non-EU airlines in the EU ETS, that international law principles were not infringed, and that the Directive did not violate the Open Skies Agreement.⁹⁶ The Court also clarified that the ETS did not involve a form of obligatory levy in favour of public authorities that could be regarded as a customary duty, tax, fee or charge on fuel held or consumed by aircraft operators, and thus ruled that the EU ETS constituted a market-based instrument rather than a fiscal measure on fuel load. Despite the Court's ruling political pressure did not cease and eventually the decision was taken to temporarily not employ the EU ETS for flights to and from aerodromes in countries outside the Union that are not members of the European Free

⁹⁰ Commission Decision of 27 April 2011 determining transitional Union-wide rules for harmonised free allocation, 2011/278/EU.

⁹¹ T-379/11, *Hüttenwerke Krupp Mannesmann and Others v Commission*, ECLI:EU:T:2012:272.

⁹² C-191/14, *Borealis Polyolefine*, ECLI:EU:C:2016:311, para 85.

⁹³ *Ibid.*, paras 95, 98–99.

⁹⁴ T-317/12, *Holcim (Romania) SA v Commission*, ECLI:EU:T:2014:782.

⁹⁵ C-366/10, *Air Transport Association of America and Others v Secretary of State for Energy and Climate Change*, ECLI:EU:C:2011:864.

⁹⁶ This agreement between the US and the EU opened up the market for more competition. See Air Transport Agreement OJ L 134, 25.5.2007, 4–41.

Trade Association or the European Economic Area or countries which have signed an accession treaty with the European Union.⁹⁷ Hence, despite the clear verdict of the Court, political expedience led to the discontinuation of the extraterritorial reach of the EU ETS in the context of aviation.⁹⁸

Finally, in an annulment case, Poland asked the Court to annul Decision 2015/1814 concerning the establishment and operation of the Market Stability Reserve on the grounds that it has been adopted pursuant to Article 192(1) TFEU rather than 192(2) which would have required unanimity voting.⁹⁹ Poland argued that, given its heavy reliance on coal and lignite, the contested decision was significantly affecting its energy market by making emission allowances more expensive. The Court cited former case law in which it had held that the choice of the legal basis of an EU measure must rest on objective factors such as its aim and content. The Court also clarified that the real and specific effects of a legal measure even if analysed would remain speculative and, hence, not be amenable to judicial review and that, as a consequence, the assessment of the effect of an EU measure on the energy policy of a Member State is not a factor that must be assessed in addition to the aim and content of the legal act.¹⁰⁰ The Court thereby quickly closed the door to examining the impact of the MSR on the national energy sector, as it then merely had to focus on the aim and content of the MSR. It established that the aim and content was to make the ETS more resilient by enabling an orderly functioning of the market and to tackle structural supply-demand imbalances.¹⁰¹ The measure at issue was therefore conceived as an instrument to cure deficiencies of the ETS rather than intending to impact the energy policies of Member States, even though it is evident that the ETS price increase that is intended and results from the MSR has precisely this effect, yet this effect was apparently held to be too indirect and not the central objective.¹⁰² In the differentiation between Articles 192(1) TFEU and 192(2) TFEU the Court clearly opted for a strict interpretation of the derogation, but failed to outline which impact on a Member State's energy policy would be required to make a measure fall under the unanimity requirement.

5. CONCLUDING DISCUSSION

This chapter has shown how the EU ETS regulation evolved over time and which challenges this market-based instrument encountered. Among these were the allowance

⁹⁷ Article 1, Decision No 377/2013/EU of the European Parliament and of the Council of 24 April 2013 derogating temporarily from Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the Community, OJ L 113, 25.4.2013, 1–4.

⁹⁸ See also J. Scott, 'Extraterritoriality and Territorial Extension in EU Law', (2014) *The American Journal of Comparative Law* 62, 87.

⁹⁹ C-5/2016, *Poland v European Parliament and Council of the European Union*, ECLI:EU:C:2018:483, para 24.

¹⁰⁰ *Ibid.*, paras 41 and 42.

¹⁰¹ *Ibid.*, paras 54 and 55.

¹⁰² J. Gundel, 'Umweltrecht: Marktstabilitätsreserve – Handel mit Treibhausgasemissionszertifikaten – EuGH (Zweite Kammer)', Urteil vom 21.6.2018 – C-5/16 (Republik Polen / Europäisches Parlament) (2018) *Europäische Zeitschrift für Wirtschaftsrecht* 915–20.

prices deemed too low to stimulate a climate transition, over allocation and surplus (over supply), allowance theft and fraud, but also fundamental changes in the allowance allocation system. The evolution of the EU ETS has been characterized by frequent legal changes that have transformed EU climate law into a hugely complex legal system.

From the cases examined above, it appears that the CJEU has issued important judgments: it has performed its role as arbiter between the Commission and Member States, and sided with the Member States in several cases during the first and the second trading phase; it supported important decisions from the EU legislator, particularly with regard to the inclusion of aviation related to third countries and the scope of the directive. Yet, the chapter also shows that the policy dynamics evolved faster than the case law, so that, in the end, the case law was overhauled by regulatory developments, as has happened regarding aviation and also *ex-post* adjustments.

The examination has also shown that, in areas where there was frequent conflict between the Member States and the European Commission, such as in the context of NAPs, the ETS has been transformed by the policy makers into a system featuring harmonized allocation rules. That the ETS is strongly shaped by policy makers rather than by the Court can also be seen in the context of the fraud episode of the ETS. In that situation, hardly any cases were brought before the Court, and action was swiftly taken by the Commission.

It would of course be unfair to hold the taking of a conservative approach against the Court, as its restrictive interpretation on legal standing of undertakings constitutes well-established case law. However, the Court has also shown itself to be quite formalistic, when it examined the relationship between energy policy and environmental policy in the annulment case brought by Poland. It seemed that the Court preferred to support the policy objectives of the ETS without duly considering the directness of dependencies between high allowance prices and energy policy.

Moreover, the above cases have shown that legal issues against the regulatory framework of the EU ETS have often to be raised in front of national courts. A more active stance in the area of climate change in general may be expected by society at large, as more policy questions are brought in front of the court by parties who do not see their interests sufficiently reflected in the EU ETS legislation. In *Carvalho*, an action has been brought against the European Parliament and the Council to request the Court to declare several EU measures unlawful, insofar as they would implement a 2030 GHG reduction target of -40 per cent below 1990 levels.¹⁰³ The applicants *inter alia* submitted that the targets were set without due examination of the EU's capability to reduce GHG emissions and mainly stemmed from the ambition to attain targets that were set prior to the Paris Agreement in a 'most cost-effective' manner and that the EU would be capable of attaining a 2030 target of -50– -60 per cent below 1990 levels.

While the case has been declared inadmissible by the Court for lack of legal standing, it points towards further national litigation. Should national courts indeed oblige Member States to adopt more ambitious climate policies, this would raise questions for the current regulatory framework and the compatibility of more stringent national measures with the EU ETS.

¹⁰³ T-330/18, *Carvalho and Others v Parliament and Council*, ECLI:EU:T:2019:324.