

Emissions Trading – Legal Issues with the Third Allocation Period

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The rules governing the allocation of emission allowances will change radically for the third allocation (trading) period starting in 2013: the allocation of allowances for emissions trading will be based on uniform European provisions. There will no longer be any free emission allowances for electricity production; all allowances will have to be purchased at auction instead. By contrast, industry will be eligible for a free allocation of emission allowances based on uniform Union-wide benchmarks, however these benchmarks are very onerous. A decision, which set out the rules, including the benchmarks of greenhouse gas

emissions performance, was formally adopted by the European Commission on 27 April 2011. The demands on installation operators during the allocation process, which is supposed to be concluded by as early as autumn 2011, are therefore greater than they were before, and will also present a challenge in terms of timeframe.

Keywords:

Emissions trading – Third allocation period 2013 – Allocation rules – Carbon leakage – Benchmarks

Emissionshandel – Rechtliche Probleme der 3. Zuteilungsperiode

Die Regeln für die Zuteilung von Emissionsberechtigungen werden sich für die dritte Zuteilungsperiode ab 2013 einschneidend verändern: Die Zuteilung von Berechtigungen für den Emissionshandel erfolgt auf der Grundlage einheitlicher europäischer Regelungen. Für die Stromproduktion wird es keine kostenfreien Emissionsberechtigungen mehr geben, diese müssen vielmehr in vollen Umfang ersteigert werden. Für die Industrie erfolgt hingegen eine kostenfreie Zuteilung von Emissionsberechtigungen auf der Grund-

lage von europaweit einheitlichen Benchmarks, die jedoch sehr streng angesetzt werden. Die Anforderungen an die Anlagenbetreiber im Zuteilungsverfahren, welches bereits bis Herbst 2011 abgeschlossen sein soll, sind damit höher als bisher und auch zeitlich eine Herausforderung.

Schlüsselwörter:

Emissionshandel – Dritte Zuteilungsperiode 2013 – Zuteilungsregeln – Verlagerungsrisiko – Emissionswerte

Le commerce d'émissions – problèmes juridiques concernant la troisième période d'allocation

El comercio de emisiones – problemas jurídicos con el tercer período de asignación

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1 Introduction and overview

Emissions trading in Europe currently finds itself in a radical phase of transition to the third allocation period [1]. The first allocation period from 2005 to 2007 was seen as a pilot phase and, in particular, allowed the necessary infrastructure to be set up. This first period is now over and the emission allowances from that period have been cancelled. The scheme was “tightened up” in the second allocation period from 2008 to 2012, which was also the commitment period under the Kyoto Protocol. The allocation rules will become even more stringent in the upcoming third allocation period from 2013 to 2020, with auctioning being the general method of allocating emission allowances.

2 Allocation rules in the third allocation period

The existing emissions trading scheme based on Directive 2003/87/EC [2] has now been amended by Directive 2009/29/EC [3], which entered into force in the middle of 2009 and must be transposed into national law by 31 December 2012.

2.1 Structural principle of the Directive: Union-wide harmonisation

A key structural element of the new Directive 2009/29/EC is Union-wide harmonisation of both the cap on available emission allowances and of the allocation rules. This struc-

tural principle was based on the experience gained from emissions trading during the first and second allocation periods. During those periods, the 27 Member States of the EU each had the opportunity to set their own national emission reduction targets and national allocation rules. In the Commission's view, however, this led to different competitive conditions for enterprises in the different Member States and thus to distortions of competition, which were prejudicial to achieving the objectives of the European internal market. The Directive therefore now lays down a uniform cap and uniform allocation rules.

2.1.1 Uniform cap

Previously, each Member State stipulated a national cap on allowable emissions. The plan from 2013 onwards is for the exclusive application of a single, Union-wide uniform cap on the number of emission allowances available for issue. This cap is based on the EU-approved target for reducing greenhouse gas emissions (20 % by 2020). According to Commission Decision of 22 October 2010 [4], the total absolute Union-wide quantity of allowances to be issued amounts to 2,039,152,882. This quantity is to decrease annually by a linear factor of 1.74 % so that by 2020, no more than 1,720,000,000 allowances are allocated Union-wide.

2.1.2 Uniform allocation rules

Apart from the cap, the allocation methodology is also being harmonised Union-wide. Previously, Member States stipulated their own allocation rules in National Allocation Plans (NAPs). However, this led to different allocation rules in each country and thus to distortions of competition within the internal market. This is to be avoided from now on thanks to Union-wide uniform allocation methodologies. As a general rule, emission allowances will be auctioned and may only be allocated free of charge in exceptional cases, which, admittedly, are very broadly defined.

2.2 Auctioning

From 2013 onwards, all electricity-generating installations will have to purchase 100 % of their emission allowances at auction. This applies to both incumbent installations and new entrants. Member States may keep the revenues generated from auctions but must use 50 % of the revenues for climate protection purposes.

The Directive did not contain any detailed provisions on the timing and administration of auctions. It merely stipulated that auctioning had to be conducted in an open, transparent, harmonised and non-discriminatory manner. The Commission laid down detailed auctioning rules in a Regulation of 12 November 2010 ("Auctioning Regulation") [5]. The main issue in dispute during consultation prior to the adoption of this Regulation, namely whether several different auction platforms should be permitted, was essentially resolved in that the general objective is to have a common auction platform, but Member States may appoint their own auction platforms during the first five years. Germany, the United Kingdom and Poland "opted out" of the common platform in the middle of February 2011 and plan to

appoint their own national auction platforms, which are still to be determined as part of a national tendering and award process.

Two products are to be auctioned, namely two-day spot and five-day futures. Two-day spot means emission allowances auctioned for delivery at an agreed date no later than the second trading day from the day of the auction, and five-day futures are emission allowances auctioned for delivery at an agreed date no later than the fifth trading day from the day of the auction.

Auctions are conducted weekly on a regulated market. Auctions are to have a single-round format. Bidders initially make their bids within a given bidding window. Bids are not disclosed, so in keeping with the sealed-bid principle, bidders cannot see the bids submitted by other bidders. Auctions follow a uniform-price format, in other words, each successful bidder pays the same price, the so-called auction clearing price. The minimum volume that may be bid for is 1000 emission allowances for futures and forwards or 500 allowances for two-day spot and five-day futures per lot. Apart from installation and aircraft operators with an operator holding account, regulated investment firms and financial services institutions may also apply for admission to bid. They may act as intermediaries, particularly for smaller enterprises that cannot or do not wish to participate in the auction themselves.

2.3 Free allocation

There is an exception to this basic principle of auctioning allowances whereby allowances are allocated free of charge in order to give preferential treatment to certain sectors, particularly industry, and to offset the risk of "carbon leakage".

2.3.1 Industry and cogeneration

Unlike the electricity sector, industry is unable to pass on the additional costs of emissions trading by factoring them in to its prices, so they should receive a free allocation. The allocation is based on Union-wide product benchmarks.

Nevertheless, industry will also be required to gradually transition to full auctioning by 2020. In 2013, 80 % of emission allowances will still be allocated free of charge. Thereafter, the free allocation will be decreased each year by equal amounts resulting in a 30 % free allocation in 2020, with a view to reaching no free allocation in 2027.

A similar gradual transition to full auctioning by 2027 is also proposed for the allocation to district heating and high efficiency cogeneration in respect of the production of heating and cooling, for which the allocation is still free at present.

2.3.2 Carbon leakage

By contrast, sectors affected by the problem of "carbon leakage" are to be allocated 100 % of their allowances free of charge. This problem arises because previous international climate change summits have been unsuccessful in securing an international agreement outlining uniform climate protection standards. It was already clear dur-

ing negotiations on the Emissions Trading Directive that the EU was aiming to achieve an ambitious international agreement on climate change. However, in the event that other developed countries did not participate in any such international agreement, this could lead to an increase in greenhouse gas emissions in third countries where industry may not be subject to comparable carbon constraints. This could also put certain energy-intensive sectors which are subject to international competition at an economic disadvantage, which, in turn, could undermine the environmental integrity and benefit of actions by the Community. This is because the economic pressure of emissions trading and international competition could force energy-intensive industries in particular to close production facilities in the EU and relocate them to third countries.

To address the risk of carbon leakage and the associated increase in CO₂ emissions, certain sectors that are both energy-intensive and also subject to strong international competition are to be given preferential treatment. This preferential treatment is to be given in the form of a free allocation of 100 % of emission allowances to the sectors concerned. The Emissions Trading Directive contains detailed criteria for determining these sectors. A sector is deemed to be exposed to a significant risk of carbon leakage if the additional costs caused by emissions trading would lead to an increase in production costs of more than 5 %, and the intensity of trade with third countries (defined as the ratio between the total value of exports to third countries plus the value of imports from third countries and the total market size for the Community) is above 10 %, or if either of those two criteria exceeds 30 %. In a Decision of 24 December 2009 [6], the Commission relied on these criteria and NACE code to determine 164 sectors deemed to be exposed to a significant risk of carbon leakage. According to that decision, the sectors manufacturing basic iron and steel, aluminium, paper and paperboard, flat and hollow glass and lime and cement, for example, receive a free allocation. However, the free allocation applies only until an international agreement is adopted, creating uniform global climate protection standards and thereby uniform competitive conditions. This list therefore currently only applies for 2013 and 2014 and is to be reassessed for the period thereafter.

2.4 Allocation on the basis of benchmarks

To the extent that allowances are allocated free of charge to industry and sectors affected by carbon leakage, the allocation is to be based on Union-wide uniform benchmarks.

These benchmarks are no longer to be set based on best available techniques (BAT). Instead, the “front runner” principle applies: the starting point for setting benchmarks is the average performance of the 10 % most efficient installations in a sector in the EU in the years 2007 and 2008. In principle, for each product one benchmark should be defined. Benchmarks are therefore determined exclusively based on the product, regardless of the technology or fuels used or the geographic location of the installation (“one product – one benchmark”).

The Commission defined benchmarks for 52 products in its Decision of 27 April 2011 [7]. The benchmarks are expressed in tons of carbon dioxide per ton of product produced. For example, the benchmark value for sintered ore is 0.171 allowances/t, for hot metal 1.328 allowances/t, for EAF carbon steel 0.283 allowances/t and for EAF high-alloy steel 0.352 allowances/t. It has to be noted that in all these benchmark values all processes directly or indirectly linked to the actual process are included (“system boundaries”) [8]. Where no product benchmark has been set for a certain product on the list, a strict hierarchy of fallback approaches governing allocation methodologies applies: where no product benchmark is specified, a heat benchmark applies. This applies to measurable heat imported to, exported from or generated by the installation. The heat benchmark is 62.3 allowances/TJ and thus roughly corresponds with the benchmark for natural gas. Where it is not feasible to measure heat, the next fallback approach is a fuel benchmark for other fuel consumption not used to generate electricity. The fuel benchmark is 56.1 allowances/TJ, which is also roughly equivalent to the benchmark for natural gas. The fourth method for determining emission allocation involves an approach for process emissions. Process emissions are carbon emissions that do not stem from combustion, but from chemical syntheses involving the oxidation of carbon, for a primary purpose other than the generation of heat. In this case, allowances are allocated on the basis of historical emissions, reduced only by a factor of 0.97.

The specific amount of allowances allocated to an installation is then calculated by multiplying the applicable benchmark by the historical activity level of each “sub-installation”, reduced if applicable by a correction factor.

Historical activity levels are based on median production either in the period 2005 to 2008 or in the period 2009 to 2010, whichever level is greater. Theoretically, installations are supposed to be divided into individual “sub-installations” in order to determine the benchmark and calculate the historical activity level. Sub-installations are to correspond, where possible, to the physical parts of the installation. After applying the benchmarks and the historical activity level to each sub-installation, the emissions of each sub-installation are then added up to calculate the allocation for the installation as a whole, which may not be exceeded.

Finally, various correction factors may apply. The “cross-sectoral correction factor” is particularly worthy of note in this context. This correction factor applies if the sum of the individual allocations for each sub-installation exceeds the cap on available emission allowances. The individual allocation decisions are reduced by creating an appropriate quotient so that the cap is not exceeded.

2.5 Key issues

The allocation methodology described above applies to incumbent installations. The Commission Decision of 27 April 2011 also contains special provisions in the event of capacity changes, i.e., for new entrants, changes to capacity and the cessation of operations.

2.5.1 New entrants

New entrants are defined as installations that have obtained a greenhouse gas emissions permit for the first time after 30 June 2011. There are two matters to note in relation to this definition: firstly, from a timing perspective it should be highlighted that installations already qualify as new entrants if they obtain a greenhouse gas emissions permit from the middle of this year onwards rather than from the date on which the third allocation period commences (1 January 2013). Secondly, the relevant date is the date on which the greenhouse gas emissions permit is issued, and not the date on which operation commences.

As for incumbent installations, allowances are then allocated on the basis of the benchmarks. Obviously, no historical activity levels are available for new entrants, so the product benchmark is multiplied by a standard capacity utilisation factor, which is yet, however, to be determined by the Commission. In the case of heat and fuel benchmarks and process emissions, the “relevant capacity utilisation factor” is to be applied, but it is yet to be determined by the Member States.

Allowances are then allocated from a reserve for new entrants, which is supposed to represent 5 % of the overall budget of available emission allowances. Allowances are allocated from the reserve on a “first come, first served” basis having regard to the date on which the applications are received. So earlier applications will receive allocations first. However, this gives rise to the risk that the reserve for new entrants will be used up relatively quickly, and further new entrants will no longer receive a free allocation. The EU Commission therefore intends to assess whether a “queuing system” should be put in place when half of the amount of allowances set aside for new entrants has been issued. This is intended to ensure that access to the reserve is managed in a fair way. However, the reserve for new entrants will not be topped up.

2.5.2 Changes to capacity

Specific allocation rules also apply in the case of capacity extensions and capacity reductions. The starting point for determining any such changes is the initial installed capacity. This is the average of the two highest monthly production volumes in the years 2005 to 2008 or within the first six months following the start of normal operation, assuming continuous production. The decisive factor is therefore the actual capacity and not the technical capacity stipulated in the permit.

Similarly, if the capacity of an installation is reduced, the amended permit is no longer relevant. Instead, allowances for a capacity extension will only be allocated after 30 June 2011 if the following conditions are met: an identifiable physical change is made, and this increases a sub-installation’s capacity by at least 10 % compared to its initial installed capacity before the change, or the sub-installation to which the changes relate has a significantly higher activity level resulting in an additional allocation of more than 5000 emission allowances per year, which must represent

at least 5 % of the preliminary annual number of emission allowances allocated free of charge for this sub-installation before the change. The allocation for capacity extensions is then calculated as for new entrants, and the emission allowances are also allocated from the reserve for new entrants.

Similarly, in the case of significant capacity reductions, there must be a physical change leading to a significant decrease in a sub-installation’s initial installed capacity and its activity level of the magnitude considered to constitute a significant capacity extension. In the event of a capacity reduction, the emission allowances allocated are reduced accordingly as of the year following the year in which the capacity reduction took place.

2.5.3 Cessation of operations

Finally, an installation may cease operations. The conditions for the cessation of operations are more clearly defined than under the previous law. An installation is deemed to have ceased operations if its permit has expired or is withdrawn, or if operation of the installation is technically impossible. Of particular note is the condition whereby an installation is deemed to have ceased operations if it is not operating and it is technically impossible to resume operation, or the operator cannot establish that the installation will resume operation at the latest within six months after having ceased operation. Where an installation ceases operation, no allowances may be issued to the installation as of the year following the cessation of operations.

Lastly, the Decision also lays down provisions for the partial cessation of operations. An installation is deemed to have partially ceased operations if one sub-installation, which contributes to at least 30 % of the installation’s annual emission allowances allocated free of charge, or to the allocation of more than 50,000 allowances, reduces its activity level in a given calendar year by at least 50 % compared to its initial activity level. A sliding scale then applies: the allocation is adjusted as of the year following the year during which it partially ceased operations as follows: if the activity level is reduced by 50 % to 75 %, the sub-installation only receives half of the initially allocated allowances; if the activity level is reduced by 75 % to 90 %, the sub-installation only receives 25 % of the initially allocated allowances; and finally, if the activity level is reduced by 90 % or more, no allowances are allocated free of charge in respect of the sub-installation. If the activity level increases again to reach certain thresholds, the higher allocation will be resumed.

2.6 Tight timeframe for transposition

As with any Directive, the Emissions Trading Directive must be transposed into national law. Although Member States are obliged to implement this Directive only until 31 December 2012, the Directive stipulates that Member States must communicate preliminary allocations to the Commission by 30 September 2011. This means that the national allocation process must be finalised by then. However, since the Commission Decision determining transitional Union-wide rules for the harmonised free al-

location of emission allowances was only finally adopted on 27 April 2011 and both the Directive and this Commission Decision have to be transposed in national law of the Member States, the timetable for the summer of 2011 is very tight. Ultimately, it will be almost impossible to meet the deadline of 30 September 2011.

End notes

- [1] Emissions trading law will therefore change radically, particularly in the first six months of 2011, as the legal foundations for allocations are being laid. The following article reflects developments as of the beginning of May 2011.
- [2] 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, Official Journal of the European Union L 275 of 25 June 2003, p. 32 et seq.
- [3] 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 scheme for greenhouse gas emission allowance trading of the Community, Official Journal of the European Union L 140 of 6 June 2009, p. 63 et seq.
- [4] Commission Decision 2010/634/EU of 22 October 2010 adjusting the Union-wide quantity of allowances to be issued under the Union Scheme for 2013 and repealing Decision 2010/384/EU, Official Journal of the European Union L 279 of 23 October 2010, p. 34 et seq.
- [5] 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 allowance trading within the Community, Official Journal of the European Union L 302 of 18 November 2010, p. 1 et seq.
- [6] Commission Decision of 24 December 2009 determining, pursuant to Directive 2003/87/EC of the European Parliament and of the Council, a list of sectors and subsectors which are deemed to be exposed to a significant risk of carbon leakage, Official Journal of the European Union L 1 of 5 January 2010, p. 10 et seq.
- [7] Commission Decision determining transitional Union-wide rules for the harmonised free allocation of emission allowances pursuant to Article 10a of Directive 2003/87/EC. The Draft Decision was approved by a qualified majority of the members of the Climate Change Committee in which all EU Member States are represented, on 15 December 2010. It then underwent a scrutiny by the European Parliament and the Council for three months. As neither the European Parliament nor the Council lodged objections during this period, the Decision could be formally adopted by the Commission on 27 April 2011.
- [8] However, the European Confederation of Iron and Steel Industries (EUROFER) announced on 4 April 2011, that it will initiate legal action against the Commission Decision on benchmarks for steel at the European Court of Justice. EUROFER claims that the steel benchmarks are unachievable for the steel industry and thus infringe the Directive, since the Commission did not assign the full carbon in unavoidable waste gases to the steel benchmarks.

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