



Distortion of competition by the EU's climate legislation?

*Annotations on the Emission Trading Scheme (ETS – Directive) and its
implementation in European law
(from a regulatory and constitutional perspective)*

MARKUS C. KERBER*

* The author, Prof. Dr. iur, teaches at the Technology University Berlin, Institute of Political Economy and Economic Law and at the Institute of Etudes Politiques, Paris.

Abstract

The executive legislation initiated by the European Commission to implement the ETS Directive, approved by the European Parliament on 18 December 2008, proves the institutional mess in the procedure of European legislation and gives further weight to doubts as to whether the ecological ratio of ETS and its application will turn out to be a source of competitive restraints rather than an improvement of entrepreneurial competitiveness. This is even more true after the Commission's erroneous overestimate of emissions data in 2005, after their release in 2006, which qualify ETS as legally disproportionate. More ETS-regulation giving free allowances to energy consuming industries of exposed sectors (carbon leakage) is a catalogue of exemptions impossible to determine precisely without executive legislation elaborated by the Commission. This bargaining is taking place within the "nether world" of comitology thus leaving doubts as to the true respect of the rule of law set by the new ETS Directive.

As a matter of fact, the definition of sectors exposed to the risk of carbon leakage entitles the industries concerned to claim the allocation of free allowances and thus to be treated equally to those industries expressly mentioned in statistical qualifications, such as the NACE-code. As a matter of fact, the NACE-Code is merely mentioned in Consideration N° 19 of the Directive as a possible method to identify and evaluate the sectors of industry menaced by carbon leakage: This method "should" only be applied "as a starting point" "where appropriate". Consideration N° 19 is therefore far from focusing the Implementation of Art. 10 a N° 9 following on the NACE-Code. However, the identification of the industries outlined is legally constrained to abide by the principle of equal treatment, ruled by the European Court of Justice as a cornerstone of Community Law. Apart from this legal constraint, which the Commission will have to pay more tribute to, there is an obvious economic reason for equal treatment of similarly exposed sectors: If industries are equally exposed to the risk of carbon leakage, the recourse to arbitrary statistical methods without reference to the factual situation, would make the Commission an agent to distort competition instead of being the guardian of the Treaty. Thus the Commission would forget the guiding objective of the European Economic Community as established in Art. 3 I g of the Treaty, "a system ensuring that competition in the internal market is not distorted".

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I. Introduction and subject matter

On 23 January 2008, the European Commission submitted a proposal for a directive of the European Parliament and of the Council amending Directive 2003/87/EG so as to improve and extend the greenhouse gas emission allowance trading system of the Community. A modification of the criteria mentioned in annex III by the comitology procedure did not seem to be possible. The codecision procedure pursuant to Article 251 of the Treaty was hence chosen. Following extensive internal deliberation in the European Parliament (EP)¹ and in the trialogue between the Commission, EP and Council², the EP on 17 December adopted in the first reading the so-called energy package and, as part thereof, the above-mentioned Directive after a corresponding resolution by the European Council on December 11th and 12th, 2008. Pursuant to Article 251 IV of the Treaty, this Directive (hereinafter ETS Directive) is deemed to be adopted and came into effect on the 20th day following its publication in the Official Journal of the European Union³.

Parallel to this, the Directive of the European Parliament and of the Council so as to include aviation activities in the scheme for greenhouse gas emission allowance trading within the Community was adopted⁴. ETS is hence soon to be applied on an EU-wide level.

However, the discussion of the regulatory legitimacy of the ETS Directive and its implementation in European law is not over. On the contrary, in view of the results of expert reports commissioned by the Federal Government⁵, one will have to expect that the debate on the economic and ecological rationale of ETS (i.e. of emission trading) will continue. Furthermore, the problematic features specific to the European executive legislation for the ETS Directive will have to be considered. In legislative terms, the "climate package" is far from being applicative law and hence binding upon the Member States. Large parts of the ETS Directive – above all, the provisions concerning the harmonisation of free allocation – call for executive

¹ By a report from MEP Doyle on 11 June 2008 followed by a discussion and voting in the Committee on Environment of the Parliament on 7 October 2008.

² On 6 November, 11 November, 17 November, 25 November, 4 December and 13 December, for example.

³ This publication is still pending.

⁴ Directive 2008/101/EG of the European Parliament and of the Council of 19 November 2008 so as to include aviation activities in the scheme for greenhouse gas emission allowance trading within the Community. Official Journal of the EU of 13 January 2009 L 8/3.

⁵ Refer to "Analyse des von der EU-Kommission am 23. Januar 2008 vorgelegten Energie- und Klimapakets im Hinblick auf die gesamtwirtschaftlichen und sektoralen Auswirkungen beim produzierenden Gewerbe in Deutschland", submitted by EEFA Energy Environment Forecast Analysis GmbH & Co KG on behalf of the Federal Government in December 2008.

legislation by the European Commission as a prerequisite for enabling the applicability of the Directive.

Pursuant to Article 202, last indent, of the Treaty, as well as Art. 211, last indent, of the Treaty, the Commission has the power and obligation to develop such executive legislation⁶. Irrespective of the opinion regarding the ensuing comitology procedure (i.e. the working together of the European Commission and the ministry officials of the national ministry administrations)⁷, the essentials of the ETS Directive are now to be implemented in the comitology procedure by 31 December 2009.

The following discussion addresses regulatory concerns⁸ and points to constitutional discrepancies between the ETS Directive and the related executive legislation.

This will hopefully trigger greater awareness among the expert community in the Member States outside the institutions in Brussels even before the executive legislation for the ETS Directive is submitted to the Council for voting.

⁶ Details are laid down in the Council Decision of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission, Official Journal of the EU dated 17 July 1999 L 184/23.

⁷ Affirmative: Ulrich Haltern, *Europarecht*, Tübingen 2005, p. 136. He considers the comitology procedure as a striking example of the integration mode of network co-ordination and as interest-compliant and reasonable way of managing complexity and of flexible policy management; refusing: Ernst-Joachim Mestmäcker, *Wandlungen in der Verfasstheit der Europäischen Gemeinschaft*, quoted from: Mestmäcker: *Wirtschaft und Verfassung in der Europäischen Union*, 2nd amended edition Baden-Baden 2006, pp. 67 seq.

⁸ Refer also to Carl Christian v. Weizsäcker, "Rationale Klimapolitik", *FAZ* dated 2 January 2009, p. 12.

II. Rule of law and division of power

I. Is there a sufficient authorisation basis for the ETS Directive?

The German Federal Government had considered bringing action before the ECJ against the proposal for a directive of the European Parliament and of the Council (amending Directive 2003/87/EC) so as to improve and extend the greenhouse gas emission allowance trading system of the Community⁹. The Federal Government did not consider it to be proven that the cited legal basis of Art. 175 in conjunction with the environmental targets of Art. 174 of the Treaty justifies centralisation of greenhouse gas emission trading¹⁰. Art. 175 of the Treaty only mentions the competence of the Council to decide on action programmes of the Community designed to achieve the objectives referred to in Art. 174 of the Treaty in accordance with the procedure referred to in Art. 251. According to Art. 174 of the Treaty, Community policy on the environment shall contribute to the pursuit of the following objectives: Preserving, protecting and improving the quality of the environment, protecting human health, prudent and rational utilisation of natural resources, promoting measures at international level to deal with regional and worldwide environmental problems.

Art. 174 of the Treaty hence assumes the existence of an environmental policy of the Community without such an operation being described in the Treaty. This means that the targets referred to in Art. 174 of the Treaty already induced the European legislator to consider it indispensable to issue pursuant to Art. 175 of the Treaty a Directive on centralising the entire greenhouse gas emission trading system. This may appear to be sensible from the perspective of environmental policy. However, this legal act cannot be derived from the EC Treaty as compatible with the higher-ranking principles of subsidiarity and proportionality.

That being said, in its decision of 29 November 2006 on the German draft allocation plan for the 2008 to 2012 allocation period, the European Commission went one step further in its discretionary/centralistic legal practice. The Federal Government and all other EU Member States were obliged to submit their draft allocation plans for the above-mentioned allocation period to the European Commission in 2006. This decision by the Member States has far-reaching implications in terms of economic, energy and environmental policy because it determines the total allocation volume and the rules for the allocation of emission allowances to plant operators¹¹. For the

⁹ COM 2008/0013 (COD).

¹⁰ Refer to Spieht/Hamer "Emissionshandel: Zertifikatebewirtschaftung durch Brüssel", NVwZ 8/2007, pp. 867 seq.

¹¹ Refer to www.consilium.europa.eu/uedocs/cmsunderscoredata/docs/pressdata/de/ec/9313_9.pdf.

2008 to 2012 period in question, the Federal Government's draft allocation plan foresaw annual carbon allocations of 482 million tonnes to plants obliged to emission trading. In its decision of 29 November 2006, the Commission stated that a sub-volume of 29 million tonnes would have to be subtracted from the total allocation volume and in this context referred to certain criteria in annex III of the ETS Directive¹². German authors unanimously criticised the Commission's decision against the concept of so-called period-spanning allocation rules and deemed it to be a violation of community law¹³. Literature accuses the Commission of disregarding the leeway which the ETS Directive affords to Member States for the preparation of their national allocation plans. The Commission was only entitled to verify the lawfulness with a view to adherence to the criteria in annex III to the above-mentioned Directives. The Commission was, however, not entitled to replace the respective Member State's considerations concerning its internal market and environmental policy with the Commission's own considerations in this respect. This view, which is undisputed in literature, deserves support because the decision concerning the measures which the Member States implement in order to fulfil these reduction obligations should have been left to the Member States since the ETS is limited to carbon dioxide and certain plants in the industry and energy sector when it comes to the drafting of the national reduction obligations in the form of a Directive.

If different methods were available in this context to determine the total allocation volume pursuant to the Directive, the total allocation volume determined nationally was not legally incorrect simply because the German Federal Government had applied a determination method that differed from the one applied by the European Commission. The European Commission failed to recognise this and in the case in question arrogated to itself to apply its own calculation method as the only valid way on the basis of a Directive. As a result, the Member States *de facto* empowered the Commission to centrally determine the carbon allocation volumes for the different Member States and to simply wait for the national proposals to be aligned to the Commission's own concept. This is also the Commission's medium-term goal. It is striving for a uniform European maximum to exist and for harmonised allocation rules to apply as of the year 2013. All this shows how little the European Commission abides by the forms of action (Directives) at its disposal and how it is anticipating a development of law which it considers to be politically desirable without having the power required for this.

¹² Directive 2003/ 87/EC of the European Parliament and of the Council of 13 December 2003, Official Journal EC No. L 275, p. 32.

¹³ Refer to Spieth/ Hamer NVwZ 2007, pp. 867 seq.

2. Can the Council of Ministers veto the implementing legal acts for the new ETS Directive¹⁴?

The question as to whether the principle of unanimity applies to both the Directive and the implementation legislation (refer to Art. 211, last indent, in conjunction with Art. 202 of the Treaty, 3rd indent of the Treaty) is of central importance for the coming into effect of the ETS Directive¹⁵. In this way, Germany would have the power in the Council to veto and thereby block both legal acts.

Expert opinions on this legal issue are available from *Christian Seiler*¹⁶ and *Ferdinand Kirchhof*¹⁷.

Referring to the proposal for a Directive of 23 January 2008¹⁸, *Seiler* discusses the different authorisation bases. He acknowledges the Commission's intention to create a market mechanism which burdens polluters with costs and at the same time channels the money contributed by them into environmentally efficient investments. To this effect, the volume of permissible total carbon emissions from all operators of certain facilities was set at a deliberately low level and this was then broken down to the individual plants in the form of special allowances. The short supply of emission allowances was to be increased by auctioning these allowances against payment in order to generate a clearly undistorted and long-term carbon price signal. This auctioning against payment was soon to become the principle underlying the allocation of emission allowances. The auctions to be carried out by the Member States would generate significant revenue for the national budgets. Referring to the principle of limited individual powers (Art. 5 I of the Treaty), *Seiler* outlines the permissible bases for the above-mentioned Directive:

- If the revenue from the auction is classified as a tax, the special harmonisation competence pursuant to Art. 93 of the Treaty would be applicable.

¹⁴ Emission Trading Scheme.

¹⁵ This refers to the Directive of the European Parliament and of the Council amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading system of the Community of 18 December 2008.

¹⁶ Prof. Dr. Christian Seiler, Universität Erfurt, Die Versteigerung von CO₂-Emissionszertifikaten im Lichte des europäischen Kompetenz- und Verfahrensrechts, submitted to Verband der Chemischen Industrie on 3 November 2008.

¹⁷ Prof. Dr. Ferdinand Kirchhof, Member of the 2nd Senate of the Federal Constitutional Court, Chair for Public Law at Universität Tübingen, The need for a unanimous decision in the EC Council with regard to a directive on emissions trading, submitted to BASF AG, E.ON AG, RWE AG, Gesamtverband des Deutschen Steinkohlebaus on 22 October 2002.

¹⁸ Official Journal EU 2008 No. C 118/3.

- If the ETS Directive is considered a case of general internal market implementation competence pursuant to Art. 95 I of the Treaty, this would imply that these are not tax provisions within the meaning of Art. 95 II of the Treaty.

- However, acts by the Community with the aim of achieving the environmental objectives as contemplated in Art. 174 of the Treaty pursuant to Art. 175 I of the Treaty would require that the provisions are not "primarily of a fiscal nature" pursuant to Art. 175 II (a) of the Treaty.

The legal consequences differ depending on how the auction revenues are classified in fiscal terms:

If revenues from emission allowances are taxes or charges similar to tax, this would inevitably require unanimity in the European Council (Art. 175 II a, Art. 95 II of the Treaty as well as Art. 93 of the Treaty). *Seiler* addresses the terms "tax" and "charges" in the Treaty in detail and points out that these terms are not used in the Treaty in a uniform manner across the different technical fields and not necessarily with the same meaning which is assigned to these terms in German. According to German law interpretation, the instrument of a charge for the allocation of emission allowances which is so far unprecedented is not to be classified as tax unless there is no concrete counter-performance for the charge paid in this way. Since this is obviously not the case because the purpose of the charge is to render operations more expensive, Art. 95 of the Treaty can be ruled out as a competence basis due to Art. 95 II of the Treaty. Furthermore, the charge does not constitute other indirect taxation within the meaning of Art. 93 of the Treaty. The only possible competence basis is hence Art. 175 of the Treaty. It was, however, questionable whether action on the part of the Community within the scope of Art. 251 of the Treaty was permitted or whether an unanimous resolution of the Council would have to be required because of dealing with provisions primarily of a fiscal nature (Art. 175 II a of the Treaty).

Since the Treaty solely referred to provisions primarily of a fiscal nature when it came defining the fact of the unanimity requirement, unanimity of the Council was required in order to pass a resolution concerning the Directive if a functional approach were adopted. A systematic interpretation also corresponded to this view: Art. 93 of the Treaty concerning so-called indirect taxation, Art. 95 II of the Treaty as well as Art. 175 of the Treaty for charges similar to tax all called for a unanimous decision by the Council.

With a view to all the aspects mentioned, *Seiler* hence advocates a unanimous decision by the Council by simply hearing the European Parliament.

Kirchhof's legal opinion from 2002 refers to the then proposal by the Commission for a system for trading with greenhouse gas allowances in the Community¹⁹.

*Kirchhof*²⁰ comes to similar conclusions such as *Seiler*, his reasoning is simply more hair-splitting. The nature of the finality of auctioning emission allowances is also addressed. In view of the parallel existence of two components (environmental protection and generation of revenue for the Member States) *Kirchhof* considers the payments for emission allowances to be charges similar to taxation within the meaning of Art. 175 II a of the Treaty²¹.

Accordingly *Kirchhof* concludes: The ETS Directive to create a system for trading greenhouse gas allowances in the Community can only be adopted by a unanimous Council resolution pursuant to Art. 251/175 II of the Treaty.

3. The specific element of the executive legislation: the Commission as a *de-facto* sovereign

Pursuant to Art. 211 of the Treaty²² in conjunction with Art. 202 of the Treaty²³, the Council confers upon the Commission the powers to implement the rules which the Council lays down. This conferral creates originary decision powers of the Commission which it usually exercises following consultation with a committee made up of experts from the Member States (comitology procedure). The term "implementation" has been defined in more detail in the decisions by the ECJ and states that the term "implementation" is to be widely interpreted and includes substantial leeway for action and judgment²⁴. On the other hand, key issues have to be addressed in the conferring decision. The details of the conferral of implementation powers have for the first time be laid down following a difficult debate between the individual institutions in the form of Council Decision 1999/468/EC of 28 June 1999^{25 26}.

The executive legislation is decisive for the ETS Directive which is the subject matter hereof as well as its effects. The underlying situation is, for example, the following:

¹⁹ COM(2001) 581 Final, OJ 2002/C75E/330.

²⁰ Refer to F. Kirchhof, pp. 29 seq. of the discussion.

²¹ Refer to p. 38 of the discussion.

²² (Fourth indent).

²³ (Third indent).

²⁴ ECJ, case 121/83, Zuckerfabrik Franken, Slg.121/83, Zuckerfabrik Franken, para. 1984,2039,2058.

²⁵ OJ 1999 L184/23.

²⁶ A comprehensive revision of this provision was carried out by Council Decision 2006/512/EC of 17 July 2006, OJ 2006 L200/11.

Art. 10 a of the ETS Directive deals with the transitional harmonisation of the free allocation of emission allowances. The Commission authorises itself "by 31 December 2010 to adopt Community-wide and fully harmonised implementing measures for allocating allowances referred to in paragraphs 3 - 6 and paragraph 8, including any necessary provisions for a harmonised application of paragraph 9 e". Art. 10a paragraph 8 aims at allocating free allowances in the years 2013 to 2020 to plants "in sectors or sub-sectors which are exposed to a considerable risk of carbon leakage" pursuant to Art. 10a paragraph 1 to the amount of 100% of the quantity specified on the basis of the measures contemplated in paragraph 1. The sectors and sub-sectors referred to in paragraph 8 are identified pursuant to Art. 10 a, paragraph 9 by 31 December 2009 and following this every five years by the Commission following discussion in the European Council on the basis of the criteria listed in paragraphs 9 a, 9 b, 9 c and 9 d. The question as to when a sector and or sub-sector is exposed to a considerable risk of carbon leakage is handled by way of a presumption. Pursuant to Art. 10 a paragraph 9 b of the ETS Directive, carbon leakage and/or the considerable risk of carbon leakage are assumed if:

a) the sum of direct and indirect additional costs induced by the implementation of this Directive would lead to a substantial increase of production cost, calculated as a proportion of the Gross Added Value, of at least 5%;

b) the non-EU trade intensity defined as the ratio between total of value of exports to non-EU plus the value of imports from non-EU and the total market size for the Community (annual turnover plus total imports) is above 10%.

Notwithstanding this presumption²⁷, a sector or sub-sector is deemed to be exposed to a significant risk of carbon leakage if:

- " the extent to which the sum of direct and indirect additional costs induced by the implementation of this Directive would lead to a substantial increase of production cost, calculated as a proportion of Gross Added Value, of at least 30%;

- the non-EU trade intensity defined as the ratio between total of value of exports to non-EU plus value of imports from non-EU and the total market size for the Community (annual turnover plus total imports) is above 30%."

This shows the enormous definition power of the Commission as the implementing legislator. Even observers who are not lawyers and who have for several years been regarding with favour and have generally supported the Commission's ETS policy

²⁷ It is irrelevant at this point whether this is a rebuttable presumption of fiction.

refer to this as a "discretionary practice" of the Commission²⁸. Even following the definition of the above-mentioned list of sectors and sub-sectors, the Commission still has the possibility to add every year at its own initiative or on request of a Member State a sector and/or sub-sector to the list referred to in paragraph 8 of Art. 10 a if it can be demonstrated in an analytical report that this sector or sub-sector qualifies for the criteria below, following a change that has a substantial impact on the sector's activities (Art. 10 a para. 9, p. 2). But it goes even further: Pursuant to Art. 10 a paragraph 9c, the list of sectors or sub-sectors which are exposed to a substantial risk of carbon leakage may be supplemented after completion of a qualitative assessment.

In view of this far-reaching influence by the Commission in agreement with the members of the related specialist committees, it is no wonder that the lawfulness of the implementation measures adopted by the committee process is generally subject to the control of the ECJ. However, another hearing of the European Parliament is still required if the committee has an important role in the performance of the basic legal act and if the modification of the committee process materially affects the global balance of the distribution of responsibilities between the Commission and the Council.

4. Substantive-law barriers for the European Commission as the implementation legislator, in particular, the principle of equal treatment

Although the European Commission in agreement with the comitology procedure retains the above-mentioned, very far-reaching powers on the executive legislation for the ETS Directive, it will not be able to free itself from its legal obedience to the principle of equal treatment in terms of substantive law. This principle means that identical facts may not be treated differently without justification. The importance of the principle of equal treatment for the final make-up of the list referred to in Art. 10a paragraph 8 is obvious. The consideration of certain enterprises within the scope of paragraph 8 must correspond not just with the criteria mentioned there. Instead, a refusal to include certain enterprises in the sectors referred to in paragraph 8 must contain, in addition to facts justifying such refusal, sufficient reasons for denying equal treatment when compared to other enterprises which will receive free allowances between 2013 and 2020.

The principle of equal treatment in conjunction with the principle of proportionality belongs to the outstanding legal principles which the European Court of Justice applies at least *in abstracto*.

²⁸ In particular, the trial phase of the ETS: Ellerman, The EU Emission Trading Scheme: A Prototype Global System? Discussion Paper 08-02/August 2008 p. 9.

In the *Arcelor Atlantique et Lorraine* case, the European Court of Justice defined the range of the principle of equal treatment more precisely in its ruling of 16 December 2008 in the context of the ETS Directive which is of interest here. The question submitted in the preliminary ruling procedure concerned the compatibility of the principle of equal treatment with the system of emission allowance trading for greenhouse gases introduced by a Community Directive. This required a complex consideration of the facts. Arcelor had brought action before the French Supreme Administrative Court (*Conseil d'Etat*) demanding that the provision in the implementation decree of ETS Directive 2003/87 CE of 13 October 2003 be held to be void. This national implementation decree, for its part, had adopted the wording of the annex to the Directive in question with regard to the industrial sectors and the gases referred to therein.

Arcelor, an enterprise in the steel producing and steel processing industry, was of the opinion that effective legal obligations could be imposed upon it under the ETS Directive as long as comparable industry sectors – i.e. the aluminium and plastic industries – were released from such obligations. Since French constitutional law does not ban differentiation on the basis of a principle of equal treatment, the French Supreme Administrative Court submitted to the ECJ the question as to whether the ETS Directive (2003/87) was compatible with the principle of equal treatment under Community law to the extent to which the Directive applied the Community-wide system of emission allowance and emission quota trading to the steel industry without including the aluminium and plastic industries at the same time²⁹.

In the above mentioned case, the ECJ negated the incompatibility of the provision in question in the implementation decree of the French Republic with the principle of equal treatment in Community law. Although the reasoning can only be supported in part, it provides an insight into the way in which the principle of equal treatment will affect how sectors and sub-sectors are determined pursuant to Art. 10 a, paragraphs 9 b and c.

The ECJ initially implicitly affirmed the permissibility in principle of the ETS Directive 2003/87 with reference to the authorisation basis of Art. 175 of the Treaty and – mentioning the arguments of the Advocate General – addressed the question as to whether the less favourable treatment of the steel producing industry when compared to the aluminium and plastic industries is compatible with the principle of equal treatment under Community law. In this context, he mentioned in advance that the ETS Directive is a legislative experiment, i.e. a pioneering project. In view of the directly apparent need for action due to the (largely postulated) relationship between carbon emissions and climate change, the Community legislator had particularly generous leeway for its action which the ECJ was only able to examine

²⁹ Refer to ECJ cit. op., marginal reference 22.

with a view to gross errors in the discussion of the facts³⁰. It extensively refers to the expert reports from 2001 submitted by the Parliament, the Council and the Commission. According to these reports, the carbon emissions by the steel industry – at least in 1990 – amounted to a multiple of the comparable emissions by the chemical industry and the non-iron-producing industry. In view of the experimental phase of Directive 2003/87³¹, the ECJ does not consider the exemption of the chemical and plastic industries compared to the steel industry under the ETS Directive to be a violation of the principle of equal treatment³².

Although the ruling is not fully convincing because it gives the Community legislator leeway which may be considered as too generous, and because it even releases the legislator in fact from court control with regard to the suitability of the measures proposed, the reasons for the rulings make it possible to outline those arguments which can be put forward in relation to Commission in order to ensure the equal treatment of economically identical situations and/or comparable industries".

In an exemplary manner, the Advocate General³³ summarises the ECJ's argumentative examination scheme as follows:

"A restricted review (of the ECJ, author's note) relating to observance of the principle of equal treatment may be presented schematically as follows:

- "the Court seeks first to establish whether the differentiation applied by the legislature serves objective criteria, that is to say relative to a legally permissible objective pursued by the legislation in question;
- the Court also ensures, again in order to avoid any arbitrary conduct, that the internal cohesion of the legislation in question is maintained, that is to say that the objective criteria adopted by the legislature and the weighting it has decided to give them are observed;

³⁰ ECJ op. cit. marginal reference 57. In his comments, the Advocate General addresses these statistical studies in much more detail. He refers to the statistics of the European pollutant emission register for the year 2001. According to these statistics, emissions by the chemical sector accounted for a total of 5.35% and by the aluminium sector for 2% of global emissions by industrial activities in the European Union, whilst emissions by the steel sector totalled 5.4% and by the glass, ceramics and construction materials sector to 2.7% and by the paper and printing sector to 1%. However, these figures could not be used as a basis because they failed to distinguish between direct and indirect emissions by the sectors concerned.

³¹ The Advocate General mentions that it is in principle possible pursuant to Art. 30 of the Directive to adapt the system of monitoring greenhouse gas emissions at an administrative level in the light of the experience with the application of this Directive.

³² Refer to ECJ, op. cit, marginal references.69 seq.

³³ Opinions of the Advocate General of 21 May 2008, case 10/127/07, marginal reference 36.

- finally, the Court ascertains whether the different treatment introduced is appropriate in relation to the objective pursued and, in this regard, usually confines itself to verifying that the measure adopted is not manifestly inappropriate.”

This would give the Commission a clear yardstick in order to define in detail the vague legal terms within the scope of the legal acts to be performed – in particular, with regard to the industries exposed to the risk of carbon leakage – without exposing itself to the reproach of arbitrary unequal treatment.

5. What are the implications of the proportionality principle for the executive legislation in the case of ETS?

The principle of equal treatment which is also applicable in European Community law means that not only the regulatory aims of infringements upon freedom and property must be justified by facts, but that the interventions themselves must also be suitable, required and reasonable in order to achieve the aim³⁴.

The suitability of ETS - as the Directive implicitly admits³⁵ – is questionable if other industrialised nations or large polluters do not sign the expected international convention because this could ultimately prevent the global limitation of greenhouse gas emissions. As a matter of fact, this could lead to an increase in emissions in those countries where industry is not subject to comparable carbon constraints. This risk – hence called carbon leakage – motivated the legislator of the Directive to allocate allowances free of charge to those industries which, due to their energy consumption and trade intensity, would not be forced but at least motivated to relocate to countries without carbon constraints. This exception which is described in detail in Art. 10 a of the Directive does hence not generate privileges for certain sectors in a manner comparable to the areas exempt from the cartel ban. Instead, this is a legislative prevention measure by the Directive legislator in order to avoid the verdict of non-proportionality. The allocation of allowances free of charge to industries exposed to the risk of carbon leakage pursuant to Art. 10 a I No. 8 is hence a non-discretionary administrative act. The enterprises concerned hence have a right to demand financial subsidies or inclusion in the list mentioned in Art. 10 a Nos. 9a seq. because this listing, for its part, is a precondition for free allocation of allowances. Listing itself is hence also a non-discretionary administrative act to which the principle of proportionality is fully applicable. If not all enterprises facing the risk of carbon leakage are entitled to claim free allocation, they can have this process

³⁴ On the importance of the principle of proportionality in the ECJ's rulings, refer to Mestmäcker/Schweitzer, *Europäisches Wettbewerbsrecht*, 2nd edition, München 2004, § 3 marginal reference 54.

³⁵ Refer to the ETS Directive of 18 December 2008, reasons No. 19.

examined in court. Even more: The ETS Directive will run the risk of qualifying as in toto non-compliant with Community law if a Member State or an enterprise concerned refers the case to the ECJ.

Should the case thus be referred to the court, the ECJ will no longer be able to limit itself to the reference to the basic suitability of ETS to achieve the climate aim of reducing carbon emissions as it did in the Arcelor-Mittal case because the allocation categories for emission allowances do not reward emission-saving energy generation and/or energy consumption. *Benz/Sturm* for example, state without being contradicted that a coal-fired power station in Germany receives around twice as many allowances as a new gas-fired power station even though the latter supplied the same amount of electricity³⁶. Such counter-incentives do not lead to the desired investment in lower-carbon technologies.

³⁶ Benz/Sturm. Weichenstellung für den europäischen Emissionshandel, Wirtschaftsdienst 2008, pp. 810-813.

III. Internal market and climate policy through ETS: Does the *telos* of the Treaty ("undistorted competition") have to bow to climate policy?

The analysis of the exception provision of the ETS Directive under the aspect of the applied principle of equal treatment must be supplemented by an analysis of the consequences of ETS *in abstracto* under competition aspects and of the competition effects of discriminating allocations of (free) emission allowance *in concreto*.

1. Climate policy versus competition?

Art. 3 I g of the Treaty sets forth the task of the EC to create "a system ensuring that competition in the internal market is not distorted". For this purpose, the Treaty has provided various instruments, notably competition policy, since the establishment of the EEC. This normative orientation of the EC towards a system of undistorted competition is in line with the *telos* of the internal market pursuant to Art. 14 of the Treaty. This is defined as an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured³⁷. In order to achieve this internal market, Art. 12 of the Treaty prohibits discrimination for reasons of nationality to which individuals and enterprises can directly refer³⁸.

The ETS Directive of 18 December 2008 makes the Member States discriminate between energy generating and energy consuming enterprises by passing external (environmental) costs on as internal costs of the enterprises. As of 2013, it will force companies to obtain allowances depending on the extent of their carbon emissions; initially within the scope of free allocation and as of 2013 against payment. Certain enterprise categories (sectors exposed to carbon leakage) will be exempt from this – for a limited term – through free allocations. The factual justification of this special treatment has not yet been questioned because postulates of environmental policy develop legitimacy *eo ipso*. The question concerning the legal legitimacy of the ETS Directive becomes all the more relevant – beyond the ECJ's Arcelor/Mittal ruling.

Compared to the traditional principles of the EC (competition / internal market / prohibition of discrimination), the legal basis of the above-mentioned Directive appears to be quite meagre. Pursuant to Art. 175 of the Treaty, the EC's environmental policy contributes towards the pursuit of the objectives mentioned below, such as the preservation and protection of the environment. In contrast to the

³⁷ Refer to Mestmäcker/Schweitzer, *Europäisches Wettbewerbsrecht*, München 2004 § 2 marginal references 6 seq.

³⁸ Refer, in more detail, to Mestmäcker/Schweitzer, *op. cit.* § 2 marginal references 39 seq.

telos of competition and the internal market, these are postulates for a possible policy rather than authorisation provisions for a mandatory task of the community.

The connection between ETS and the generation of revenue by the Member States which has its basis in Community law, has been the subject matter of correspondingly controversial debate³⁹.

This clearly means that in the event of a collision between climate policy and the principles of competition and internal market, the secondary law of the Community based on Art. 175 of the Treaty does not take precedence. Distortions of competition and obstacles to the implementation of the internal market by ETS would hence be legally relevant and would trigger a legal obligation on the part of the responsible bodies of the Commission (Directorates General Competition and Internal Market).

The points of ETS which are critical from a competition perspective are striking:

- As *Denny Ellerman*⁴⁰ correctly states, ETS is the first multinational "cap-and-trade system for greenhouse gases". This uniqueness raises not only the academic question as to whether ETS might serve as a prototype, but also the practical question as to which effects it will have, all the more so since there will initially be no copies since the major non-European industrialised nations, such as the US, India, China and Brazil either definitely reject ETS (China) or postpone its implementation for an indefinite time (US). In contrast to this, the ETS Directive expects that an international climate convention is about to materialise almost immediately⁴¹. One can expect that ETS climate protection in the EC will lead to more economic growth in the refuser countries due to increased production by the energy-intensive industry in conjunction with increasing carbon emissions. In contrast to this, the competitiveness of energy-intensive industries in Europe as the pioneer continent is likely to decrease⁴² and incentives to relocate production to refuser countries are likely to emerge. In the following, this will be referred to as the geopolitical distortion of competition to the disadvantage of the European industry.

³⁹ Refer to the discussion in II. 1.).

⁴⁰ Denny Ellerman, *The EU Emission Trading Scheme: Prototype Global System?* Discussion Paper 08-02/ August 2008.

⁴¹ Refer to the ETS Directive of 18 December 2008. Reasons Nos. 3 and 6. According to reasons No. 3, the EU's climate policy obligations are to be contingent upon other industrial nations committing themselves to comparable emission reductions.

⁴² Refer, in more detail, to III.2.).

- Free allocation pursuant to Art. 10 a VIII of the ETS Directive to industries found to be exposed to a substantial risk of carbon leakage is in itself difficult to handle in a non-discriminatory manner.

However, discriminatory granting or refusal are relevant for Community law not just under the aspect of the principle of equal treatment, but additionally have the potential to distort competition within the internal market.

- Privileged treatment of energy producers in the recently acceded Member States (Poland) will put state-of-the-art, low-emission plants, for example, in Germany, at a disadvantage. At the same time, the French industry would receive a massive competition advantage because this country's industry covers most of its energy demand from nuclear energy (85%).
- Finally, the power of the Member States pursuant to Art. 10 a IVa of the ETS Directive to grant financial support to industries exposed to a substantial risk of carbon leakage "in order to compensate for the costs of greenhouse gas emissions which are transferred to the electricity price" is highly problematic. Although this power is contingent upon compatibility with the rules of the Treaty for state aid pursuant to Art. 87 of the Treaty⁴³, it will hardly be possible to achieve this "compatibility" without clarifying the ranking between competition-orientated aid rules and climate policy postulates because state aid in the above-mentioned sense has an intrinsic distorting effect on competition and can hardly be controlled with a view to target achievement.

2. The empirical/quantitative description of the impact of climate policy on competitiveness

Despite these competition-relevant items, *Baron et al.* have confirmed that ETS practice in its current form has not affected the competitiveness of European industry⁴⁴. They examine the *impact* of ETS in certain industries (cement, steel, oil refinery, aluminium) and, applying quantitative methods, come to the above-mentioned result. This result that has been obtained using abstract methods is in contrast to the loud protest voiced by the industry concerned. *Benz/Sturm*, on the

⁴³ On the legal framework for government subsidies for environmental protection, refer to: European Commission, OJ of 3 February 2001 C 373 seq.

⁴⁴ Baron, Lacombe, Quirion, Reinaud, Walter, Trotignon: Competitiveness under the EU Emissions Trading Scheme, Working Draft.

other hand, frankly admit that even the continued practice of free allocation will not be able to prevent the loss of market shares by the enterprises concerned.⁴⁵

On behalf of the European Commission, *Peterson/Klepper* from the Kiel Institute for the World Economy⁴⁶ examined the impact of the EU's climate policy on competitiveness. They first define that competitiveness within the meaning of their study referred to the ability of a sector of industry – rather than of a single enterprise – to succeed on export markets⁴⁷. The study hence addresses the question as to how sectors of industry – rather than which single enterprise – will be able to succeed despite the EU's climate policy. It further tries by way of the DART model⁴⁸ to quantify the comparative disadvantages of the EU's climate policy for European industry. As a result, *Peterson/Klepper* judge the adverse impact to be small, but they concede that comparative disadvantages would arise for the energy-consuming industry. In this context, they refer to earlier calculations of the revealed comparative advantage (RCA) which – on the basis of the hypothetical allocation of emission allowances – already came to a similar conclusion.⁴⁹

The national allocation plan had a crucial impact on the welfare losses of the respective EU Member State⁵⁰. It is not always clear whether a model is required in order to justify this result. Apart from this, *Peterson/Klepper* limit their study to those sectors of industry which are particularly affected by ETS. The losses of competitiveness⁵¹ found here – i.e. the losses claimed to be measurable would be compensated for by the improved competitiveness of the processing industry (and trades)⁵².

Alexeeva-Talebi/Böhnnger/Moslener already discussed the term "competitiveness" in more detail in 2007 and supplemented the approaches for measuring impairment

⁴⁵ Benz/Sturm, Wirtschaftsdienst 2008 pp. 810 seq.

⁴⁶ Peterson/Klepper, The Competitiveness Effects of the EU Climate Policy, Kiel Working Papers N° 1464/November 2008.

⁴⁷ Ibidem S. 6.

⁴⁸ Dynamic Applied Regional Trade Model. This model (refer to the detailed explanations in Peterson/Klepper, ibidem, pp. 27 seq.) is a multi-regional, multi-sector aggregation of the world economy which covers 22 regions and 11 industrial sectors, including the energy sector. The model is based on competition-optimal factor markets and considers the exogenous factors of population growth, savings rate, labour productivity and rate of return on capital. It only considers carbon emissions and the EU's related climate policy.

⁴⁹ Klepper/Peterson, The EU Emissions Trading Scheme: Allowance Prices, Trade Flows, Competitiveness Effects, European Environment 14 (4), pp. 201-218.

⁵⁰ Peterson/Klepper, op. cit., p. 27.

⁵¹ The relative world market share (RWS) is meant here.

⁵² Peterson/Klepper, op. cit., p. 27.

thereof by ETS⁵³. They differentiate not only between the competitiveness of individual enterprises and sectors, but also introduce "national competitiveness" in addition to these two categories⁵⁴. In contrast to the competitiveness of individual enterprises and sectors, the competitiveness of an entire economy was measured by the "ability to attract" rather than by the "ability to earn or to sell". *Alexeeva-Talebi/Böhringer/Moslener* thereby close a theoretical gap in relation to the approach by *Peterson/Klepper*. They consider not just the effect of the EU's climate policy on the export performance by a sector of industry or by an enterprise. Instead, they address the impact of ETS on the economy as a whole. The advantage of this is that the analysis covers not just ETS-induced comparative disadvantages for sectors, but also addresses the competitive disadvantage of a location in the future. Far-sighted are the observations of *Alexeeva-Talebi/Böhringer/Moslener* on the potential of competitive distortions by free riding countries in climate legislation or its application. Countries like the US, China and India will continue to maintain their refusal of ETS as long as they can benefit from the competitive advantages which they obtain through ETS in Europe by way of carbon leakage. The EU's pioneering ETS legislation which has advanced – irrespective of a parallel initiative by the above-mentioned countries in the same direction – could hence blatantly provoke a longer-lasting refusal stance by the US, China, India and Brazil⁵⁵. *Alexeeva-Talebi/Böhringer/Moslener* hence suggest quantifying the extent of leakage because "Leakage rates reflect the impact of sub-global emission abatement strategies on comparative advantage."⁵⁶

In conclusion, *Alexeeva-Talebi/Böhringer/Moslener* confirm the adverse effect of the EU's climate policy (in particular, of ETS) on the competitiveness of energy producing and consuming enterprises, but link this to the – perhaps comforting – statement that industry which contributes only insignificantly towards carbon emissions would improve its competitiveness⁵⁷.

Since, this being said, there is no doubt that the EU's climate policy will have an adverse impact on competitiveness and the implementation of the internal market, and since only the measurability and extent of this impact are controversial among

⁵³ Alexeeva-Talebi/Böhringer/Moslener: Climate Policy and Competitiveness: An Economic Impact Assessment of EU Leadership in Emission Regulation. Paper on the 2nd Workshop on Energy and Technology on 13 July 2007 in Dresden.

⁵⁴ Alexeeva-Talebi/Böhringer/Moslener Alexeeva-Talebi/Böhringer/Moslener, op. cit, pp. 4 seq.

⁵⁵ Ibidem, pp. 8 seq.

⁵⁶ Ibidem.

⁵⁷ The simulations performed in this respect (*Alexeeva-Talebi/Böhringer/Moslener*, op cit., pp 11 seq.) can only be mentioned. A detailed discussion of these simulations is not possible.

the scientific community, *Alexeeva-Talebi/Löschel/Mennel*⁵⁸ have suggested reducing the shift of energy-intensive industries to non-European countries through border tax adjustments and integrated emissions trading. According to this proposal, environmental taxes would be levied on imported goods (produced free from ETS) and importers would be obligated (corresponding to the emissions from the production of imported goods) to obtain carbon allowances. This proposal shows the complexity of all the measures to be taken in order to adjust the distortions of competition to be expected from ETS. Although the reasons for the ETS Directive of 18 December 2008 repeatedly mention the prevention of competitive distortions⁵⁹ and the implementation of the internal market, the Commission ignores the problem from an operational perspective. This hence opens up a vast area which must be addressed without delay unless academia is to pave the way for sacrificing the *anima* of the EC – competition and the internal market – in favour of climate policy.

⁵⁸ Alexeeva-Talebi/Löschel/Mennel, Climate Policy and the Problem of Competitiveness: Border Tax Adjustments or Integrated Emission Trading? ZEW Discussion Paper N° 08-061.

⁵⁹ Refer to reasons No. 13 a, 17 a.

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