

# “Free allocation of EU ETS emission allowances to installations for electricity production from a State aid law perspective”

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## ARTICLE INFO

Marcin Stoczkiewicz (2012). Free allocation of EU ETS emission allowances to installations for electricity production from a State aid law perspective. *Environmental Economics*, 3(3)

## RELEASED ON

Tuesday, 25 September 2012

## JOURNAL

"Environmental Economics"

## FOUNDER

LLC “Consulting Publishing Company “Business Perspectives”



NUMBER OF REFERENCES

0



NUMBER OF FIGURES

0



NUMBER OF TABLES

0

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## Free allocation of EU ETS emission allowances to installations for electricity production from a State aid law perspective

### Abstract

According to in-depth examination of the free allocation of emission allowances which could be granted by the European Union Member State to electricity undertakings under the derogation established in Article 10c of Directive 2003/87/EC, this transitional free allocation will constitute a State aid measure in the meaning of Article 107(1) of the Treaty of Functioning of European Union. The recently adopted European Commission guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012 established rather general conditions and lowered the level of protection of the environment and the competition on the electricity market.

**Keywords:** emission allowances, State aid, Directive 2003/87/EC.

**JEL Classification:** K23.

### Introduction

This paper focuses on potential problems with the allowances under Directive 2003/87/EC on establishing a scheme for greenhouse gas emission allowance trading within the Community as amended by Directive 2009/29/EC (“Directive 2003/87/EC”)<sup>1</sup>. From 2013, allowances to emit carbon dioxide (CO<sub>2</sub>) will be allocated by auction in the power sector. However, certain Member States including Poland have an option to use a derogation to give transitional allocations of free allowances in the power sector to be phased out by 2020<sup>2</sup>. According to Article 10c of Directive 2003/87/EC, such transitional free allocations will only be available to installations for electricity production which are in operation by December 31, 2008 or to installations for electricity production for which the investment process was physically initiated by the same date, and that additionally meet certain legal requirements for eligibility. The purpose of the derogation is to support investment in modern electricity infrastructure and clean technologies to a value equivalent to the value of the free allowances.

This paper focuses on the problem of State aid in the meaning of Article 107(1) the Treaty of the European Union functioning in the scope of granting free emission allowances. Some Member States are planning to allocate a significant amount of emission allowances free of charge<sup>3</sup>.

The first question examined in this paper is: whether this planned free allocation will constitute State aid in the sense set out by Article 107(1) TFUE? According

to settled case law the constitutive criteria of State aid are as follows: Firstly, there must be an intervention either by the State or through State resources. Secondly, the intervention must be liable to affect trade between Member States. Thirdly, it must confer an advantage to the recipient. Fourthly, it must distort or threaten to distort competition<sup>4</sup>. According to preliminary examination all these criteria will be fulfilled in the case of free of charge allocations of emission allowances to installations for electricity production referred to in Article 10c of Directive 2003/87/EC.

The European Commission has considered State aid in tradable emission permits ever since the Community Guidelines on State aid for environmental protection was published in 2008. The Commission has stated that “Tradable permit schemes may involve State aid in various ways, for example, when Member States grant permits and allowances below their market value and this is imputable to Member States”<sup>5</sup>. The Commission, in decision practice, has assessed the national emission trading systems allocations by Member States as State aid on many occasions. For example, in its decisions concerning State aid cases N653/1999 (Denmark, CO<sub>2</sub> quotas)<sup>6</sup>, N416/2001 (the United Kingdom, emission trading allowances)<sup>7</sup>, N35/2003 (the Netherlands, NO<sub>x</sub> trading scheme) the Commission took the view that the constitutive criteria of State aid were fulfilled. In these decisions an emission allowance was considered equivalent to an intangible asset the value of which would subsequently be determined by an allowance market, and the fact that a State gave it free of charge to companies gave them an advantage. By choosing not to sell this allowance, e.g. by putting it up for auction, the State deprived itself of a resource, with the result that the advantage was funded by means of State resources. The advantage

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<sup>1</sup> Directive 2003/87/EC on establishing a scheme for greenhouse gas emission allowance trading within the Community as amended by Directive 2009/29/EC, OJ L 140/63, 5.6.2009.

<sup>2</sup> Article 10c, Directive 2003/87/EC on establishing a scheme for greenhouse gas emission allowance trading within the Community as amended by Directive 2009/29/EC.

<sup>3</sup> European Commission (DG Clima) recently adopted several decisions approving the derogation applications of several Member States. See: <http://europa.eu/rapid/searchResultAction.do?search=OK&query=CLIMACTION&username=PROF&advanced=0&guiLanguage=en>.

<sup>4</sup> Case C-280/00, *Altmark Trans* [2003] ECR I-7747, para 75.

<sup>5</sup> OJ C 82/1 from 1.4. 2008) in points 55 and 139.

<sup>6</sup> OJ C 322, 11.11.2000, p. 9.

<sup>7</sup> OJ C 88, 12.4.2002, p. 16.

was granted only to certain economic sectors or certain companies, thus making the measure selective. The companies concerned were active in markets in which there was trade between Member States, with the result that this trade was affected and market competition was, or could have been, distorted.

For the position of the Commission in Phase 1 (2005-2007) and Phase 2 (2008-2012) of the EU ETS, the letter of March 17, 2004 from the Directorates-General for Environment and Competition to the Member States is significant. In this letter the Commission presented the view that the allocation of allowances in the frame of National Allocation Plans according to Directive 2003/87/EC “may contain elements which distort competition and constitute State aid”<sup>1</sup>. This would be, for example, where a Member State allocates more allowances to undertakings than needed to cover their projected emissions during the relevant period or where a Member State over-allocates the company or the sector in the frame of NAP. Article 10 of the Directive 2003/87/EC requires Member States to allocate at least 95% of the allowances free of charge. According to the Commission, State aid will always be involved if a Member State decides to allocate more than 95% of allowances free of charge for the period 2005-2007, thereby foregoing public revenue<sup>2</sup>.

The legal framework for Phase 3 of EU ETS (2013-2020) has changed significantly and is established in Directive 2009/29/EC of the European Parliament and the Council of April 23, 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community (Directive 2009/29/EC)<sup>3</sup>. Member States shall transpose and implement this Directive by December 31, 2012. However, they shall publish and submit to the Commission, by September 30, 2011, a list of installations covered by this Directive and any free allocation to each installation in their respective territories<sup>4</sup>.

In terms of the energy sector, Directive 2009/29/EC sets up a general rule for the auctioning of emission allowances from 2013<sup>5</sup>. Pursuant to Article 10 (1) of the Directive 2003/87/EC as amended by Directive 2009/29/EC from 2013 onwards, Member States shall auction all allowances which are not free of charge in accordance with Article 10a and 10c. The regulation of Article 10c was included in the package of elements of the final compromise for the adoption of the amendment of Directive 2003/87/EC. This

Article establishes the option of a transitional free allocation for the modernization of electricity generation on the basis of an authorization by the Commission. According to Article 10c (1) of Directive 2003/87/EC by derogation from Article 10a (1) to (5), a Member State may give a transitional free allocation to installations for electricity production in operation by 31 December 2008 or installations for electricity production for which the investment process was physically initiated by the same date, provided that certain established conditions are met.

The Commission has presented its opinion regarding State aid aspects in transitional free allocation of allowances in the Phase 3 of EU ETS in the Communication “Guidance document on the optional application of Article 10c of Directive 2003/87/EC”<sup>6</sup>. According to the Commission the “free allocation of emission allowances to electricity generators and the financing of correspondent investments required by Article 10c of Directive 2003/87/EC would in principle involve State aid in the meaning of Article 107(1) TFUE”<sup>7</sup>. This opinion has been repeated by the Commission, as a general statement, in the Guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012<sup>8</sup> (“Guidelines on ETS State aid measures”). According to the Commission “The special and temporary measures provided for in the context of implementation of the ETS Directive involve State aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union”<sup>9</sup>.

As free EU ETS allowances constitute the new measure of State intervention, the question of whether this planned free allocation of allowances to electricity generators and the financing of correspondent investments under Article 10c of Directive 2003/87/EC constitute State aid in the sense set out by Article 107(1) TFUE will be examined in this paper.

If free allocation of emission allowances constitutes State aid in the meaning of Article 107 (1) of the TFEU, it will be incompatible with the internal market as a general rule and, therefore, prohibited. Therefore, the second problem examined in this paper is whether this planned free allocation may be considered to be compatible with the internal market

<sup>1</sup> Letter from Directorates-General for Environment and Competition to the Member States, 17.04.2011, ENV 2C/PV/amb/D (2004)420, p. 2.

<sup>2</sup> Letter from Directorates-General for Environment and Competition to the Member States, 17.04.2011, ENV 2C/PV/amb/D (2004)420, p. 2.

<sup>3</sup> OJ L 140, pp. 63-87.

<sup>4</sup> Article 2 and Article 11(1) of the Directive 2009/29/EC.

<sup>5</sup> Preamble to the Directive 2009/29/EC, recital 19.

<sup>6</sup> Communication from the Commission – Guidance document on the optional application of Article 10c of Directive 2003/87/EC, OJ C 99/9, 31.3.2011.

<sup>7</sup> Communication from the Commission – Guidance document on the optional application of Article 10c of Directive 2003/87/EC, para 27.

<sup>8</sup> Communication from the Commission Guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012, OJ 2012 C 158/04.

<sup>9</sup> Communication from the Commission Guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012, OJ 2012 C 158/04, para 3.

and therefore allowed, and if so, what specific conditions have to be fulfilled?

### 1. Free allocation of EU ETS emission allowances to installations for electricity production as State aid in the meaning of Article 107 (1) TFEU

Article 107 (1) of the TFEU contains a list of requirements that must all be met in order to characterize a measure as State aid. According to settled case law the conditions are as follows. Firstly, there must be an intervention by the State or through State resources. Secondly, the intervention must be liable to affect trade between Member States. Thirdly, it must confer an advantage on the recipient. Fourthly, it must distort or threaten to distort competition<sup>1</sup>. The results of an examination into whether the free allocation of EUAs under Article 10(c) of Directive 2003/87/EC will fall within the constitutive elements of State aid are presented below.

**1.1. Imputability to the Member State.** The first condition to be satisfied is twofold: the aid has to be (1) imputable to the State; and (2) granted directly or indirectly through State resources.

A measure is imputable to a Member State when it is somehow attributable to the public authorities of the State. The Court of Justice has established in the landmark Stardust case that to prove the condition of imputability it is necessary to “examine whether the public authorities must be regarded as having been involved, in one way or another, in the adoption of those measures”<sup>2</sup>. When the public authorities are granting aid directly to a given undertaking, their behavior is by definition attributable to the State (Van de Castele and Grespan, 2008).

As was mentioned before, according to the Commission, National Allocation Plans (NAPs) may contain elements which distort competition and constitute State aid. Even if the NAP did not contain any ‘over-allocation’, there would still be an element of State aid, having regard to Article 10 of Directive 2003/87, if a Member State allocated more than 95% of the allowances for the first allocation period free of charge, thereby foregoing public revenue<sup>3</sup>. This conclusion was based on the text of the Directive 2003/87/EC, especially its Article 10, called “Method of allocation”, according to which “For the three-year period beginning from January 1, 2005 Member States shall allocate at least 95% of the allowances free of charge. For the five-year period beginning January 2008, Member States shall allocate at least 90% of the allowances free of charge.” The Directive 2003/87/EC

used the word “shall” which indicates that in these periods of time the Member States didn’t have discretionary power to allocate the allowances free of charge outside the scope of 95/90%, because this was an obligation implied by the directive. The percentage of allowances that Article 10 of the Directive 2003/87/EC prescribed to be distributed free was not attributable to Member States, as they do not have any discretionary power over it. This view is supported by case law, which clarifies that, when a clear and precise EU provision, as the Directive is, requires a Member State to implement it, the transposing rules are not imputable to them (Catti De Gasperi, 2010, p. 792)<sup>4</sup>.

It is implied *a contrario* by Article 10 that the Directive 2003/87/EC left to Member States the choice to auction off a limited amount of allowances in both periods (Catti De Gasperi, 2010, pp. 787-788). Therefore in the scope of 5/10% the decision to allocate the allowances for free or sale on auction was a discretionary power of the Member States, so was imputable to the Member States (Lorenz, 2004, p. 401). Taking into account that the Directive 2003/87/EC was based on the actual Article 192 TFEU (former Article 175 EC Treaty), a lower auctioning percentage is not compatible with Article 193 TFEU, as it does not give better protection to the environment.

It should be stressed that Article 10 of the Directive 2003/87/EC has been changed by the Directive 2009/29/EC which established an auction principle. The amended Directive 2003/87 establishes auctioning as the basic principle, and explicitly stipulates that full auctioning is a rule from 2013 onwards for the power sector<sup>5</sup>. This means the EU legal obligation to grant 95% of allowances free will be removed starting from 2013. Consequently, the Member State’s decision to use the derogation established in Article 10c and allocate allowances free in Phase 3 of EU ETS will be a discretionary decision to grant aid directly to a given energy undertaking and therefore imputable to the Member State.

**1.2. Resources of the Member State.** To consider a resource as a State resource the key concept is the notion of control (Van de Castele, D. Grespan, 2008). State resources are involved where public authorities of the Member State enjoy or acquire control over the funds which finance some economic advantage granted to an undertaking<sup>6</sup>. Where the State, acting as a regulator, creates an asset owned by an undertaking,

<sup>1</sup> Case C-280/00, Altmark Trans [2003] ECR I-7747, para 75.

<sup>2</sup> Case C-482/99, French Republic v. Commission (Stardust) [2000] ECR I-4397, para 52.

<sup>3</sup> See: case T-387/04, EnBW Energie Baden-Württemberg v. Commission, para 23.

<sup>4</sup> Case T-351/02, Deutsche Bahn v. Commission, [2006] ECR II-01047, para 101-102.

<sup>5</sup> Communication from the Commission – Guidance document on the optional application of Article 10c of Directive 2003/87/EC, para 3-4.

<sup>6</sup> This conclusion implies *a contrario* from Advocate General Jacobs opinion in Stardust case, who wrote that: „State resources are not involved where the public authorities at no stage enjoy or acquire control over the funds which finance the economic advantage in issue.” Case C-482/99 French Republic v. Commission (Stardust) [2002] ECR p. I-4397.

it is necessary to determine whether that asset has an economic value and whether that value constitutes a transfer of State resources. A system in the Netherlands allowing the transfer by undertakings of trading emission allowances was held by the General Court to confer an advantage on those undertakings. The measure in question authorized the undertakings, subject to binding emission standards, to trade the emission allowances which indirectly resulted from that standard with each other, up to the limit of a ceiling applicable to each of them (Quigley, 2009). According to the General Court ruling in the NOx case “Setting up a scheme which provides for the possibility of trading NOx emission allowances on the market, the Kingdom of the Netherlands has conferred on them the character of intangible assets which the undertakings concerned are free to sell, even if they are linked to a maximum ceiling applicable to the undertaking concerned. Those assets are put at the disposal of the undertakings concerned free of charge, whereas they could have been sold or put up for auction. The Kingdom of the Netherlands has thus forgone State resources”<sup>1</sup>. Thus the measure in question entailed a financial burden for the State by foregone revenues that it could have earned. The General Court ruling in NOx case has been appealed and it is still a pending case before the Court of Justice. Nevertheless, an assessment of the measure in question made by General Court in terms of “state resources” has been accepted by Advocate General Mengozzi in his opinion in this case<sup>2</sup>.

Pursuant to Article 10(3) of the amended ETS Directive, Member States *shall* determine the use of revenues generated from the auctioning of allowances. At least 50% of the revenues *should* be used for the described purposes (to develop renewable energies, measures to avoid deforestation, the environmentally safe Carbon Capture and Storage, to increase energy efficiency, etc.). It is the Member State that has to determine the use of auctioning revenues (Ballesteros, 2010). Member States are only required to inform the Commission as to the use of revenues from auctioning of emission allowances (Article 10(3) recital 3). Therefore, it is clear that revenue from auctioning EUAs which would be forfeited by a Member State which instead makes allocations free of charge are under the control of the Member State.

It must be stressed that Member States meeting the criteria described in Article 10c of Directive 2003/87/EC are not required to use the option of transitional allocation of emission allowances free of

charge to installations for electricity production, and may well choose not to in the light of the auctioning revenues that they would forego by doing so<sup>3</sup>. Thus, the argument that the revenues foregone by free of charge allocation of emission allowances will in fact be revenues under the control of the European Union, not under the control of the Member State, has to be rejected.

Additionally, it must be stressed that any line of argumentation which refers to the *PreussenElektra* judgment (that benefits from free emissions allowances accruing to sellers arise directly from the market, as they consist in principle paid by their private trading partners who purchase the pollution permits as compensation,) is not applicable in this case. Indeed, The Court in the *PreussenElektra* case ruled that “In this case, the obligation imposed on private electricity supply undertakings to purchase electricity produced from renewable energy sources at minimum prices does not involve any direct or indirect transfer of State resources to undertakings which produce that type of electricity. Therefore, the allocation of the financial burden arising from that obligation for those private electricity supply undertakings as between them and other private undertakings cannot constitute a direct or indirect transfer of State resources either” (de la Torre, Cruz, 2001, pp. 489-501)<sup>4</sup>. But, as has been stressed by G. Catti De Gasperi, this position can easily be dismissed by simply remarking that operators do not receive any economic advantage during the sale of the permits, but rather prior to such sale, when the allocation is made by the State free of charge and the emission allowances reach their account (Catti De Gasperi, 2010, pp. 792-793).

To conclude this part of the analysis, the granting of free allowances by the Member State under Article 10 c of Directive 2003/87/EC will involve a transfer of State resources, for reasons that in such cases the State itself foregoes revenues that it can earn. These granted free of charge allowances will constitute intangible assets that could be later sold by the recipient undertaking on the market, thus generating additional revenues.

**1.3. Selective advantage.** *1.3.1. Economic advantage.* A State intervention which has the effect of improving the financial situation of a company constitutes an economic advantage. The same holds true when there is no such improvement but it turns out that without State intervention the financial situation of the company would have deteriorated (Grespan, Santamato, 2008). The notion of aid can encompass

<sup>1</sup> Case T-233/04, *Netherlands v. Commission*, [2008] ECR II-591, para 75. See: M. Könings, *Emission trading – why State aid is involved: NOx trading scheme*, Competition Policy Newsletter 2003/3, p. 78.

<sup>2</sup> Opinion of Advocate General Mengozzi in case C-279/08 P *Commission V Netherlands*, para 87-93. See: [http://curia.europa.eu/jcms/jcms/j\\_6/](http://curia.europa.eu/jcms/jcms/j_6/).

<sup>3</sup> Communication from the Commission – Guidance document on the optional application of Article 10c of Directive 2003/87/EC, para 2.

<sup>4</sup> Case C-379/89, *PreussenElektra AG*, [2001] ECR p. I-2099, para 59-60. See: F.C. de La Torre, J.B. Cruz, *A note on PreussenElektra*, *European Law Review* 2001, #26, pp. 489-501.

not only positive benefits such as subsidies, loans or direct investment in the capital of enterprises, but also interventions which, in various forms, mitigate the charges which are normally included in the budget of an undertaking and which therefore, without being subsidies in the strict sense of the word, are of the same character and have the same effect<sup>1</sup>. An economic advantage could especially derive from non-imposition on an undertaking or a group of undertakings a public burden which has been imposed on other undertakings<sup>2</sup>.

One specific case of non-imposition (or exemption) of public burden is the free of charge allocation of emission allowances. Therefore, free of charge allocation of emission allowances in the context of the general rule of auctioning of allowances from 2013 onwards for the power sector has to be regarded as an economic advantage, which the recipient undertaking would not have obtained under normal market conditions. This conclusion is confirmed both by Commission decision practice and by relevant case law. The Commission in the decisions on the Danish<sup>3</sup>, British<sup>4</sup> and Dutch NOx<sup>5</sup> schemes, pointed out that intangible assets granted by States can be later sold by the recipient undertaking on the market for emission allowances, thus generating additional revenues. Therefore, a grandfathering system based on free allocation bestows an economic advantage on covered installations. The Commission stated in the French NAP decision that: “the allocation of allowances free of charges to certain activities confers a selective economic advantage on undertakings, which has the potential to distort competition and effect intracommunity trade”<sup>6</sup>. According to the above referenced the General Court ruling in the NOx case: “the tradability of emission allowances provided for by the measure constitutes an advantage for enterprises subject to emission standards”<sup>7</sup>. Such an approach to Commission practice and case law was criticized by some scholars<sup>8</sup> and some Member States<sup>9</sup>. After all,

all, the assessment made by the General Court has been shared by Advocate General Mengozzi in his opinion in this case<sup>10</sup>.

*1.3.2. Selectivity of the measure.* An equally necessary condition for State aid to occur is that it must favor certain undertakings or the production of certain goods, a condition that can be described as the “selectivity criterion”. The criterion of “selectivity” established in the jurisdiction of the Court of Justice is very broad. This criterion should be deemed fulfilled if the aid is granted to a certain class of undertakings, for example large undertakings<sup>11</sup> or SMEs<sup>12</sup>. A measure has the character of selectivity when it gives an advantage to a certain sector of companies<sup>13</sup>. The Court of Justice in its *Adria Wien Pipeline* ruling clearly stated that a rebate on an energy tax applying only to the primary and industrial sector was indeed selective, because the measure distinguished between the manufacturing sector and the rest of the economy, including the service sector<sup>14</sup>.

It is important to note that an economic advantage constitutes State aid only if it favors “certain undertakings or the production of certain goods in comparison with other[s] ... which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question”<sup>15</sup>. This is important especially in the light of the above mentioned the General Court ruling on the Dutch NOx scheme, where the Court stated that the selectivity criterion was not satisfied and, therefore, the scheme passed the State aid test<sup>16</sup>. Nevertheless, this ruling has been recently criticized by Advocate General Mengozzi in his opinion on case C-279/08 P *Commission v. Netherlands*. AG Mengozzi has stated that: “where the system gives an economic advantage to covered undertakings, defined by taking into account objective criteria (a group of undertakings which emits NOx), those advantages have a selective character, because they favor only certain groups of undertakings”<sup>17</sup>.

The granting of free emission allowances by a Member State under Article 10c of Directive 2003/87/EC, as an exception from the general rule of auctioning, will fulfill the selectivity criterion, because it will grant

<sup>1</sup> Case C-126/01 *GEMO* [2003] ECR I-13769, para 28.

<sup>2</sup> See: case C-487/06P, *British Aggregates Association v. Commission*, [2008] ECR I-10505; case C-143/99, *Adria-Wien Pipeline*, [1999] ECR I-8365; case C-128/03, *AEM SpA v. Autorità per L'Energia Elettrica e per il Gas* oraz C-129/03, *AEM Torino SpA v. Autorità per L'Energia Elettrica e per il Gas*. [http://curia.europa.eu/jcms/jcms/j\\_6/](http://curia.europa.eu/jcms/jcms/j_6/).

<sup>3</sup> N653/1999, Denmark – CO<sub>2</sub> quotas.

<sup>4</sup> N416/2001, United Kingdom – emission trading allowances.

<sup>5</sup> N35/2003, the Netherlands – NOx trading scheme.

<sup>6</sup> Commission Decision on the French NAP of October 20, 2004, C(2004) 3982/7 final.

<sup>7</sup> Case T-233/04, *The Netherlands v Commission*, [2008] ECR C II-591, para 74.

<sup>8</sup> See: G. Catti De Gasperi (2010). Making State Aid Control “Greener”: The The EU Emissions Trading System and its Compatibility with Article 107 TFEU, *European State Aid Law Quarterly*, 4, p. 794. According to this author, for example, it has been said that the undertakings covered by the EU ETS do not benefit from the inclusion within the system because, prior to its establishment, they could freely emit without a gratuitous permit. But G. Catti De Gasperi argues that this opinion can be dismissed by simply remarking that the assumption that the emission reduction is a social services provided by polluters is inconsistent with the polluter-pays principle.

<sup>9</sup> See: Opinion of Advocate General Mengozzi in case C-279/08 P *Commission v. Netherlands*, para 64-68.

<sup>10</sup> Opinion of Advocate General Mengozzi in case C-279/08 P *Commission v. Netherlands*, para 70-74. See: [http://curia.europa.eu/jcms/jcms/j\\_6/](http://curia.europa.eu/jcms/jcms/j_6/).

<sup>11</sup> Case C-200/97 – *Ecotrade Srl v. Altiforni e Ferriere di Seriola SpA (AFS)*, [1998] ECR I-07907, para 40-41.

<sup>12</sup> Case T-55/99 – *Confederación Española de Transporte de Mercancías (CETM) v. Commission*, [2000] ECR II-03207, para 40.

<sup>13</sup> Case 173/73 *Italy v. Commission* [1974] ECR p.709, para 36.

<sup>14</sup> Case C-143/99, *Adria Wien Pipeline GmbH* ECR [2001] p. I-8365, para 48, 52-53, 55.

<sup>15</sup> Case C-88/03, *Portugal v. Commission*, [2006] ECR I-07115, para 54.

<sup>16</sup> Case T-233/04, *The Netherlands v. Commission*, [2008] ECR C II-591, para 96-100.

<sup>17</sup> Opinion of Advocate General Mengozzi in case C-279/08 P *Commission v Netherlands*, para 44.

an economic advantage to a selected group of undertakings, namely a particular, selected group of electricity production energy undertakings.

Granting emission allowances free of charge only to a certain group of electricity generation undertakings will at least distinguish between their situation and the situation of: (a) other electricity generation undertakings, which will not be granted them free of charge; and (b) new electricity generation entrants, who will not be granted them free of charge; and (c) undertakings of other sectors covered by the EU ETS system, who will have to buy the emission allowances at auction. It follows that in this case there would be selectivity (1) on the level of undertakings covered by EU ETS and others (2) in the selectivity of the undertakings covered by EU ETS, namely between electricity production undertakings which will be granted emission allowances free of charge and others.

**1.4. Effect on trade between Member States and distortion of competition.** Electricity generation is a liberalized activity in the European Union internal market. The electricity generation market is open for competition. Since the EU ETS is a Community-wide system, it is clear that the electricity generation sector is engaged in intra-Community trade (Catti De Gasperi, 2010, p. 795). According to the presumption of effect on trade and distortion of competition established in the Court of Justice ruling in case 730/90, Philip Morris “Where State financial aid strengthens the position of an undertaking as compared with other undertakings competing in intra-Community trade, the latter must be regarded as affected by the aid<sup>1</sup>”. There is no disagreement among scholars on the potential of grandfathering to fulfill the conditions of “effect on trade and distortion of competition”. The same could be said in the case of exceptional free of charge allocation of emissions allowances under Article 10c of Directive 2003/87/EC. Any allocation method granting a selective advantage to certain sectors or installations, thus strengthening their position over competitors, in fact, is likely to lead to an alteration of the conditions of competition and commerce in the EU-wide market (Catti De Gasperi, 2010, p. 795; Weishaar, 2006, pp. 271-381). The Commission has stated in the second German NAP decision that “assigning more public resources in the form of free allowances to one group of existing installations distorts or threatens to distort competition with another group of existing installations and has also cross-border effects given EU-wide trade in all sectors covered by the Directive<sup>2</sup>”.

The measure in question – free allocation of emission

allowances under Article 10c of Directive 2003/87/EC – could have an effect on trade on the internal market and could distort competition on several levels, e.g. (1) competition between incumbents and new market entrants; (2) competition between competing firms within the same Member State; and (3) competition between beneficiaries and other power plants.

According to the EU ETS Directive *undue distortions* of competition must be avoided in transitional free allocations of allowances. Several provisions under Article 10c of Directive 2003/87/EC are oriented to avoid undue distortions of competition on the electricity market. Article 10c(3) of the Directive states: “The Commission shall (...) provide guidance to ensure that the allocation methodology avoids undue distortions of competition (...)”. Article 10c(5)(e) provides that any Member State intending to allocate allowances free of charge must submit an application to the Commission which shall contain among other things “information showing that the allocations do not create undue distortions of competition”. Article 10c(6) requires the Commission to assess the application taking into account the elements set out in paragraph 5 which include the information showing that the allocations do not create undue distortions of competition, and recognizes the Commission’s capacity to reject the application or any aspect thereof, within six months of receiving the relevant information. The clear inference from these provisions of Directive 2003/87/EC is that the European legislator assumes that granting free of charge emission allowances under Article 10c will result in distortions of competition. The Commission has an obligation to prevent higher levels of these distortions, namely undue distortions.

In summary, it is clear that transitional free allocation of emission allowances under Article 10c of Directive 2003/87/EC will fulfill the conditions of “effect on trade and distortion of competition”.

**1.5. Conclusion.** According to in depth examination of the free allocation of emission allowances which could be granted by the Member State to electricity undertakings under the derogation established in Article 10c of Directive 2003/87/EC, this transitional free allocation will constitute a State aid measure in the meaning of Article 107(1) of the TFEU.

## 2. Grounds for compatibility of the free of charge EU ETS emission allowances with the internal market

Free allocation of emission allowances constitutes State aid in the meaning of Article 107 (1) of the TFEU, incompatible with the internal market as a general rule and prohibited. Therefore, the second problem examined in this paper is whether this planned free allocation may be considered to be compatible with the internal market and therefore allowed, and if

<sup>1</sup> Case 730/90, Philip Morris, para 11.

<sup>2</sup> Commission Decision on the second German NAP of 29.11.2006, para 2.2.

so, what specific conditions have to be fulfilled?

Article 107(3)(c) of the TFEU provides that aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest may be considered compatible with the common market. This exception can only be granted under strict conditions. In principle, it does not allow for aid to be granted for the development of individual undertakings, the measure in question must contribute to the development of the particular sector or region. The aid must ensure that there is an improvement in the way in which said economic activity is carried out. In applying Article 107(3)(c) the Commission must assess whether the aid is both necessary and proportionate (Hancher, 2007, p. 630).

**2.1. Commission guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012.** As was mentioned above, the European Commission has adopted new guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012 (“ETS State aid guidelines”)<sup>1</sup>.

According to the European Commission, the State aid measure, involved in the transitional free allowances for the modernization of the electricity generation, and, the investments, included in the national plans, may be declared compatible with the internal market within the meaning of Article 107(3)(c) of the Treaty, if it leads to increased environmental protection (reduction of greenhouse gas emissions) without adversely affecting trading conditions to an extent contrary to the common interest. In assessing the compatibility of an aid measure, the Commission balances the positive impact of the aid measure in reaching an objective in the common interest against its potentially negative side effects, such as distortion of trade and competition.

The Commission has declared in the ETS State aid guidelines that a State aid measure involved in the transitional free allowances, will be considered “compatible with the internal market”, only if the following criteria are met:

- ◆ the transitional free allowance granted pursuant to Article 10c of the ETS Directive and in accordance with the Commission Decision on guidance on the methodology to transitionally allocate free allowances to installations for electricity production pursuant to Article 10c(3) of

the ETS Directive and the Commission Communication on the optional application of Article 10c of the ETS Directive;

- ◆ the National Plan pursues an objective in the common interest, such as increased environmental protection;
- ◆ the National Plan includes investments in retrofitting and upgrading of the infrastructure, in clean technologies and in diversification of their energy mix and sources of supply in accordance with the ETS Directive undertaken after June 25, 2009;
- ◆ the market value of free allowances during the whole allocation period does not exceed the total costs for investments undertaken by the recipient of free allowances. If the total investment costs are lower than the market value of the allowances or the recipient of the free allowances does not undertake any investment eligible under the national plan, the recipients of free allowances must transfer the difference to a mechanism that will finance other investments eligible under the National Plan;
- ◆ the aid does not adversely affect trading conditions to an extent contrary to the common interest, in particular where aid is concentrated on a limited number of beneficiaries or where the aid is likely to reinforce the beneficiaries’ market position;
- ◆ eligible costs must be limited to the total investment costs (tangible and intangible assets) as listed in the National Plan corresponding to the market value of free allowances;
- ◆ the incentive effect is deemed fulfilled for investments undertaken as from June 25;
- ◆ eligible costs must be limited to the total investment costs (tangible and intangible assets) as listed in the National Plan corresponding to the market value of free allowances granted per beneficiary, irrespective of operating costs and benefits of the corresponding installation;
- ◆ aid must not exceed 100% of the eligible costs.

**2.2. Criticism of the Commission ETS State aid guidelines.** Taking into account the principles of the Treaty and settled case law, it is clear that the new assessment criteria of State aid measures in the context of the greenhouse gas emission allowance trading scheme adopted by the Commission shall be compatible with *the polluter pays principle* (Stoczkiewicz, 2009) established in Article 191(2) of the TFEU and with *the integration principle* established in Article 11 of the TFEU. Additionally, the new criteria shall be compatible with settled case law and settled Commission practice in terms of application of Article 107(3)(c) of the TFEU and take into account the general rule of auctioning of emission allowances established in Article 10(1) of the amended Directive 2003/87/EC. The new assessment criteria

<sup>1</sup> Commission guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012, OJ 2012 C 158/04 (“ETS State aid guidelines”).

ought to be consistent with settled Commission practice and set up conditions much more strict (or at least no less strict) than the conditions established in the Commission practice. To achieve this consistency, these criteria have to be based on general rules established in the Environmental Guidelines of 2008<sup>1</sup>. It should be noted that the Commission adopted the Environmental Guidelines of 2008 as part of the Climate and Energy package (Kutenicova and Seinen, 2008, p. 851). Therefore, the Environmental Guidelines constitute the most appropriate point of departure for establishing new guidelines.

Unfortunately, the EU ETS State aid guidelines are lowering the level of protection of the environment and competition on energy market. Under the Environmental Guidelines of 2008 the “incentive effect” is characterized as follows: “*State aid for environmental protection must result in the recipient of the aid changing its behavior so that the level of environmental protection will be higher than if the aid had not been granted. However, investments which increase the level of environmental protection may at the same time increase revenues and/or decrease costs and thus be economically attractive in their own right. Therefore, it needs to be verified that the investment concerned would not have been undertaken without any State aid.*”<sup>2</sup>

According to the EU ETS State aid guidelines “*The incentive effect is deemed fulfilled for investments undertaken as from June 25, 2009*”<sup>3</sup>. The Environmental Guidelines of 2008 defining also the “necessity of aid” condition: “*Investment may be necessary in order to meet mandatory Community standards. Since the company would have to comply with those standards in any event, State aid to meet mandatory Community standards that are already in force cannot be justified*”<sup>4</sup>. In the EU ETS State aid guidelines the Commission didn’t set up “necessity of aid” condition in terms of aid involved in optional transitional free allowances for the modernization of electricity generation.

The “proportionality of the aid” condition under the EU ETS State aid guidelines is also established at a lower level than in the Environmental Guidelines of 2008. According to the Environmental Guidelines of 2008: “*Aid is considered to be proportional only if the same result could not be achieved with less aid. In addition, proportionality may also depend on the de-*

*gree of selectivity of a measure. [...] In particular, the aid amount must be limited to the minimum needed to achieve the environmental protection sought. Therefore, eligible costs for investment aid are based on the notion of the extra (net) cost necessary to meet the environmental objectives. This concept implies that, in order to establish how much aid can be granted, all the economic benefits which the investment gives the company must in principle be subtracted from the additional investment costs*”<sup>5</sup>. Following this principle, the eligible costs under EU ETS State aid guidelines should be limited to the extra investment costs necessary to realize CO<sub>2</sub> reduction by “*investment in retrofitting and upgrading of the infrastructure and clean technologies*”<sup>6</sup> as compared to “*business as usual*” investment (scenario)<sup>7</sup>. The Commission decided to define eligible costs in the EU ETS State aid guidelines more general, as “*Eligible costs must be limited to the total investment costs (tangible and intangible assets) as listed in the National Plan corresponding to the market value of free allowances granted per beneficiary, irrespective of operating costs and benefits of the corresponding installation*”. The aid intensity established in the EU ETS State aid guidelines is also unusually high: “*Aid must not exceed 100% of the eligible costs*”<sup>8</sup>.

## Conclusions

Free allocation of emission allowances which could be granted by the Member States to electricity undertakings under the derogation established in Article 10c of Directive 2003/87/EC will constitute in principle a State aid measure in the meaning of Article 107(1) of the TFEU.

A State aid measure involved in the transitional free allowances for the modernization of the electricity generation and the investments included in the national plans may be declared compatible with the internal market within the meaning of Article 107(3)(c) of the TFEU if it leads to increased environmental protection (reduction of greenhouse gas emissions) without adversely affecting trading conditions to an extent contrary to the common interest.

The recently adopted European Commission guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012 established rather general conditions and lowered the level of protection of the environment and the competition on the electricity market.

<sup>1</sup> Community Guidelines on State Aid for Environmental Protection, 2008/C 82/1, OJ C 82/1, 1.4.2008.

<sup>2</sup> Community Guidelines on State Aid for Environmental Protection, 2008/C 82/1, OJ C 82/1, 1.4.2008, para 27.

<sup>3</sup> Commission Guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012, OJ 2012 C 158/04, para 40.

<sup>4</sup> Community Guidelines on State Aid for Environmental Protection, 2008/C 82/1, OJ C 82/1, 1.4.2008, para 29.

<sup>5</sup> Community Guidelines on State Aid for Environmental Protection, 2008/C 82/1, OJ C 82/1, 1.4.2008, para 30-31.

<sup>6</sup> Article 10c (1) of Directive 2003/87/EC.

<sup>7</sup> See for example para 105, para 117 of Community Guidelines on State Aid for Environmental Protection, 2008/C 82/1, OJ C 82/1, 1.4.2008.

<sup>8</sup> Commission Guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012, OJ 2012 C 158/04, para 42.

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