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TITULO: STATE AID AND ALLOCATION OF LIMITED AUTHORIZATIONS AND GRANTS. OVERVIEW OF THE CASES*

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ABSTRACT: The granting of free allowances by the Member State under Directive 2003/87/EC may involve a transfer of State resources for the reason that in such cases the State itself foregoes revenues that it could earn, were it to auction them. Free of charge allocation of emission allowances in the context of the general rule of auctioning of allowances from 2013, has to be regarded as an economic advantage, which the recipient undertaking would not have obtained under normal market conditions. If free allocation of 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. The Commission practice and Decisions of the Court of Justice considers that Article 107 (3)(c) of the TFEU is the only basis for the consideration of free of charge emission allowances as being compatible with the internal market. Moreover, we have to take into account if state aid might be covered by the scheme of general rules of assessment established in the Environmental Guidelines of 2008 and if so, under what conditions.

KEY WORDS: environment, emissions trading, allowance allocation, national allocation plan, competitive distortions, state aid.

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SUMARIO:

I. Introduction.

The question of involvement of State resources arises also in the context of EU´s Emissions Trading Scheme. The EU´s scheme initially provided for a pilot phase (Phase I, 2005-2007) and a Phase II (2008-2012) correspond to the first commitment period of Kyoto. In the first trading period, it was open to Member States to auction up to 5% of the allowances allocated pursuant to the different NAPs[1]. But most Member States choose not to auction this percentage therefore foregoing revenue and satisfying the amounts with the Member States resources criterion under Article 107 (1) TFEU.

The chances for a greater potential for aid came along with the second trading period. During Phase II allowances must be backed by an Assigned Amount Unit (units each equal to one tonne of carbon dioxide equivalent) which can be traded between Kyoto´s parties; by allocating for free or below market price to EU ETS undertakings Member States are foregoing potential revenue from selling those Units[2]. Considering that Member States are obliged by ETS Directive[3] to distribute 90% of allowances for free during phase II, only 10% could be auctioned so only in those cases and if those allowances are distributed for free or below market price we would talk about State aid. Nevertheless, DG of competition has not acted against Member States in relation to this matter. As we will see, the Commission has rather preferred to deal with matters related with NAP´s approval.

During Phase III, that is during 2013-2020, there will be little space for State Aid. The EU ETS Directive requires 70% of allowances to be auctioned by 2020, rising to 100% by 2027[4].

We will see that the 2009 EU ETS Directive states that Member States´ use of auctioning revenues is subject to the State Aid rules, and that information

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[1] See description in: M.C. ALONSO GARCÍA, "El nuevo régimen jurídico del mercado europeo de derechos de emisión de gases de efecto invernadero", Actualidad Administrativa, 2012, forthcoming.

[2] SEINEN, A.T., State aid aspects of the EU Emission Trading Scheme: the second trading period, Competition Policy Newsletter, 3, 2007, pág. 100.

[3] Directive 2009/29/EC of the European Parliament and of the Council of 23th of april 2009, amending Directive 2003/87/EC so as to improve and extend greenhouse gas emission allowance trading scheme of the Community, OJ 2009 L140/63.

[4] See Article 10c ETS Directive.

provided to the Commission on the use of those funds does not mean that no notification of aid is necessary under Article 108(3) TFEU[5].

Article 107 (1) TFEU defines prohibited State aid as an advantage granted by a Member State or through State resources, which actually or potentially distort competition policy, favours certain undertakings or the production of certain goods, and has an effect on trade between Member States. While State aid is in principle prohibited (art. 107 (1) TFEU), paragraphs 2 and 3 set out ways in wich aid can be exempted from this general prohibition.
Exemptions are premised on a recognition that markets not always work properly alone and that sometimes intervention from State is necessary and benefits consumer welfare[6]. In accordance to it, the Treaty expressly provides that for certain non-economic reasons, that include environmental reasons, legitimate the grant of State Aid.
Nevertheless, the Commission has recently develop a more rational approach to the conditions in which State aid may be justified, founded on economical reasons[7] searching for a substancial reduction of state aid[8]: "8. Further, it is important to realize that state aid does not come for free. Nor is state aid a miracle solution that can instantly cure all problems. Tax payers in the end

[5] ETS Directive, §19.

[6] U. SCHWALBE, "Welfare effects of financing state aid" (2006) *European State Aid Law Quaterly* 55.

[7] Commissioner Kroes, September the 14th 2006, "Industrial Policy and Competition Policy" (Speech/06/499, Fordham University School of Law) stated: "My top priority as Competition Commissioner has been a comprehensive reform of our state aid rules. Our objective is to help Member States to spend only as much taxpayers' money on subsidies as is absolutely necessary, and to target that expenditure as effectively as possible. So our motto is "less and better targeted state aid". We look first to the markets to deliver, and only where there are clear gaps does state aid play a role".

And D. HILDEBRAND and A. SCHWEINSBERG, "Refined economic Approach in European State Aid Control-Will it gain Momentum? (2007) 30(3) *World Competition* 449.

More recently, the Communication on State aid modernisation (COM(2012) 209 final) may the 8th 2012, states that: "The Europe 2020 growth Strategy recognises the role of State aid for growth and its capacity "to actively and positively contribute to the Europe 2020 objectives by prompting and supporting initiatives for more innovative, efficient and greener technologies, while facilitating access to public support for investment, risk capital and funding for research and development".

[8] Commission´s State Aid action plan**, "**State aid action plan - Less and better targeted state aid: a roadmap for state aid reform 2005-2009 ({SEC(2005) 795}/ COM/2005/0107 final", And D. HILDEBRAND and A. SCHWEINSBERG, "Refined economic Approach in European StateAid Control-Will it gain Momentum? (2007) 30(3) *World Competition* 449.

have to finance state aid and there are opportunity costs to it. Giving aid to undertakings means taking funding away from other policy areas. State resources are limited and they are needed for many essential purposes, such as the educational system, the health system, national security, social protection and others. It is therefore necessary for Member States to make choices transparently and to prioritise action". Recently, the Communication on State aid modernisation (COM(2012) 209 final) may the 8th 2012, states that: "The Europe 2020 growth Strategy recognizes the role of State aid for growth and its capacity "to actively and positively contribute to the Europe 2020 objectives by prompting and supporting initiatives for more innovative, efficient and greener technologies, while facilitating access to public support for investment, risk capital and funding for research and development".
Therefore, the issue is not whether environmental considerations should be taken into account in assessing the compatibility of the State aid with the Treaty, this is in general out of question. The problem is to determine the right balance ought to be in taking them into account. The Commission´s 2008 *Guidelines on State Aid for environmental Protection*, emphasizes the important role that State Aid can play in achieving environmental goals[9] considering that environmental protection is an objective of common interest which, in some circumstances, may justify the granting of State aid.

The question that arise in this moment is whether the emissions trading schemes can or should be considered as State Aid and if so not compatible with the Treaty.

II. Some general remarks regarding EU´s regime?

First of all, the analysis of the existence of an aid regarding the approval of the National Allocation Plans by the Commission, does not replace nor repeal the application of the procedures laid down in articles 107 and 108 TFEU[10]. In

[9] See Guidelines, § 5-14.

[10] M. MEROLA and G. CRICHLOW, "State Aid in the Framework of the EU Position after Kyoto: an analysis of Allowances granted under the Co2 Emissions Allowance Trading Directive", (2004) 27 (1)*World Competition* 25; M. LORENZ, "Emission Trading-The State Aid Dimension" (2004) *European State Aid Law Quaterly* 399; M. TORRE-SCHAUB, "La naissance d´un nouveau marché: le système britannique de commerce d´allocations

analyzing the National Allocation Plans the Commission make a *prima facie* exam of any aid that may contain these plans but does not apply the procedure set out in the TFEU, but the one of Directive 2003/87/EC (of the European Parliament and of the Council of 13 october 2003 establishing a scheme for greenhouse gas emission allowance trading within the community and amending council directive 96/61/EC). In fact article 9.3 of Directive 2003/87/CE states that: "Within three months of notification of a national allocation plan by a Member State under paragraph 1, the Commission may reject that plan, or any aspect thereof, on the basis that it is incompatible with the criteria listed in Annex III or with Article 10. The Member State shall only take a decision under Article 11(1) or (2) if proposed amendments are accepted by the Commission. Reasons shall be given for any rejection decision by the Commission".

So, Directive does not contain a general prohibition nor recognize an exception. Therefore the Commission preliminary assessment valuation of the National Allocation Plans should not be regarded as definitive. In the Order of the Court of First Instance (Third Chamber), 30 April 2007, Case T-387/04 *Energie Baden Wuerttemberg AG vs. Commission*, the CFI stated: "In the first place, although it is true that Directive 2003/87/EC, in particular the fifth criterion in Annex III thereof, itself envisages the possibility of conflicts between the provisions of a NAP and the rules on State aid, and therefore requires the Commission to take account of those rules in the review procedure under Article 9(3) of the directive. In addition, it cannot be excluded that, under certain circumstances, notification of a NAP under the second subparagraph of Article 9(3) of Directive 2003/87 might also constitute notification for the purposes of Article 88(3) EC, or might even have to be regarded as such" (§132). As for that, it does not eliminate the possibility of applying if necessary the procedure of articles 107 and 108 TFEU[11], as confirmed by the Order mentioned above.

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d´emissions de gaz à effet de serre", (2004) *Revue International de droit économique* 227; S. WEISHAAR, *Towards Auctioning: the transformation of the European Greenhouse Gas Emissions Trading System: present and future Challenges to Competition Law*, Kluwer, 2009.

[11] A. JOHNSTON, "Free allocation of allowances under EU emissions Trading scheme: legal issues", Climate Policy, 6/2006, pág. 119; A. T. SEINEN, "State aid aspects of the EU Emission Trading Scheme: the second trading period", Competition Policy Newsletter, 3, 2007, pág. 100.

The order specifies the procedures to follow and the criteria to take into account in assessing state aid under the National Allocation Plan implementation of agreements with the criteria set out in Annex III of Directive 2003/87[12]. In the order of the Court of First Instance (Third Chamber), 30 April 2007, it is stated that:

> "(20): Under Article 13(1) of Directive 2003/87, allowances are to be valid only for emissions during the period for which they are issued;
> (21) In a joint letter from the Directors General of DG Environment and DG Competition to the Member States, dated 17 March 2004, on the subject of 'State Aid and [NAPs]', the Commission set out the procedures to be followed and the criteria of which it intended to take account in assessing possible State aid granted in the context of the implementation of NAPs in accordance with the criteria laid down in Annex III to Directive 2003/87".

In the letter above mentionned of march 2004[13], the Commission indicated that Phase I allocations would not be review for compliance with the State aid rules, but not such assurance was given for Phase II.

III. Do NAP constitute State aid?

In several Decisions, adopted before the approval of the Directive, the Commission found that the grant of allowances constituted aid without analysis of selectivity, as long as the criteria or elements of the definition of aid established in articles 87.1 EC (107.1 TFEU) were met. For example, in *UK Emission Trading Scheme*,[14] the UK´s allocation of free emissions trading allowances (pre-EU ETS) along with the incentives paid to undertakings to participate in the trading scheme[15] that the national emissions trading scheme included, was found to constitute aid. Specifically, "The state thus

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[12] Order of the Court of First Instance (Third Chamber), 30 April 2007, Case T-387/04 *Energie Baden Wuerttemberg AG vs.*

[13] Letter of 17 march 2004, HNV C2/PV/amh/D (2004) 420149.

[14] Case N416/01.

[15] See, Commission letter of 28 th November 2001(Brussels, 28.11.2001 C(2001)3739 fin),"The UK Government will make available an incentive totalling £43m per annum (£30m net of tax) for five years, spread across all entities entering the trading scheme taking on absolute emissions targets on the basis of the greenhouse gases (GHGs) they emit both directly or indirectly within the UK."

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

"The value of these permits is predicted to be considerable. By the envisaged arrangements, the State foregoes revenue, which could derive from auctioning the emission permits". Despite the fact that the free allocation of allowances constituted and advantage from State resources, the Commission decided to consider the aid compatible with article 87.3 EC Treaty based on the idea that the scheme makes a valuable contribution to environmental policy (whyle not affecting adversely trading conditions). Nevertheless, the Commission stated on the one hand that the scheme is not the preferred option of the Commission and, secondly, that it should be probably modified once the Directive is approved.

A similar solution was adopted regarding the *Danish Emissions Trading Scheme*[16] for the period 2001-2003 and its free allocation of transferable emissions permits to electricity producers established by the Danish government. The arrangements were considered to constitute aid granted by a Member State or through State resources in any form whatsoever. But, the Commission stated also that aids pursuing environmental objectives must normally be assessed in the light of the Community guidelines on State aid for environmental protection. "However, the current guidelines do not take into account such a new form of State intervention as a system of tradable emission permits. Therefore, the Commission has assessed the Danish system for trade in CO2 emission permits on the basis of Article 87(3)(c) EC, and has decided that an exemption can be granted"[17].

Concerning measure C 18/2001 (ex case N123/2000), United Kingdom, Climate Change Levy for the free allocation of allowances for companies entering into Climate Change Agreements. The levy was introduced in order to help meet the UK's international greenhouse gas abatement obligations and to progress towards the goal of reducing CO2

[16] Case N653/99 (Decisions 29/3/2000, 28/11/2001 and 24/6/2003). See Commission letter of 12th april 2000 (Bruxelles, den 12.04.2000 SG(2000) 508).

[17] See Commission letter of 12th april 2000 (Bruxelles, den 12.04.2000 SG(2000) 508).

emissions. It covered the use of fuel for lighting, heating and motive power in industry, commerce, agriculture, public administration and other services. The Commission decision not to raise objections to four types of exemptions either because they were not deemed to be State aid (exemption for electricity from renewable sources and for Good Quality CHP) or else because they were compatible with Article 87(3) of the EC Treaty (exemption for public transport and rail freight, exemption for companies entering into Climate Change agreements) - gives clearance for the implementation of the major elements of the Climate Change Levy. However, on one point, the Commission decided to open the formal State aid investigation procedure. Under the current UK legislation, energy used partly for fuel purposes and partly for non-fuel purposes, for example in a chemical reduction, will be exempt from the CCL. The Commission wanted to consider further whether this exemption constituted State aid and, if so, whether it was compatible with the Community's State aid rules.

In all those early Decisions, the Commission stated that the requirements of article 87.1 EC Treaty (article 107.1 TFEU) were ment. The state allocates a number of transferable emission permits free of charge to undertakings. So, she considered that the State thus provides an intangible asset for free, which can be sold on a market to be created. The fact that there will be a market is a sign of the value of the asset being allocated, so it is considered as an advantage. By those arrangements, the State forgoes revenue, which could derive from auctioning the emission permits. The granting of this advantage involved a transfer of state resources, and finally, the Commission considered that the advantage in question were selective, affecting trade between MS and distorting or threatening to distort the market. Therefore, the Commission assessed in different cases that emission permits on the basis of Article 87(3)(c) EC, and decided that an exemption could be granted.

In fact, in order to consider allocation of allowances as state aid in the sense of the Treaty, it is necessary that the following conditions are met:
-there must be free or at least, at a price lower than the fees paid in the market and affect the state´s resources

- aids must be selective, affecting trade between States and distort competition.

In all those early Decisions, the Commission did not analyse the selectivity criteria.

IV. The problem of the selectivity criteria.

However, since those Decisions, the issue of selectivity has become very contentious.

The first decision of the ECJ on the allocation of allowances and their relationship with state aid does not refer to the national allocation plans but the legislation transposing the Directive 2001/81/EC of Parliament and the Council of 23 October 2001 on national emission schemes for certain atmospheric pollutants, which requires states not exceed certain ceilings of emissions of various compounds in their respective territories, that the Netherlands embodied in a market in emission rights. In *Netherlands v. Commission*[18], the Court annulled the Commission Decision of 24 June 2003[19] by declaring that the market for emitting nitrogen oxides created by the Dutch State constituted aid compatible with the common market. The Kingdom of the Netherlands puts forward two pleas alleging the infringement first, of Article 87 EC, and second, of the requirement to state reasons.

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[18] Case T-233/04, CFI april the 10th 2008.

[19] Netherlands sought the annulment of the Decision on the grounds that it was not a real help and therefore was not subject to the reporting and notification requirements of Art. 108 TFEU.

In its Decision the Commission stated that "…accordingly decided that the NOx emission trading scheme constitutes State aid within the meaning of Article 87(1) of the EC Treaty. In addition the Commission concludes that such aid is compatible with the common market in accordance with Article 87(3)(c) of the EC Treaty and Article 61(3)(c) of the EEA Agreement. By taking this decision, the Commission considers that the scheme makes a valuable contribution to the Community environmental policy while not adversely affecting trading conditions to an extent contrary to the common interest. It remains that the scheme is not the preferred option of the Commission, especially as regards the 'dynamic cap', according to which the environmental outcome is more uncertain and the costs of administration and compliance are higher than in a 'cap and trade' system. The Dutch authorities are requested to provide the Commission annually with a report on the implementation of the aid. Any change in the conditions under which the aid is granted must be notified in advance".

Regarding the first plea, the Kingdom of the Netherlands, supported by the Federal Republic of Germany, claims that the measure in question does not constitute an advantage financed through State resources and, in the alternative, that the condition of selectivity is not fulfilled.

After analysing the meaning of state aid, according to what the General Court considers that :

> 65: "The notion of aid can encompass 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".
> 66: "It therefore follows that a measure which grants certain undertakings an advantage entailing an additional burden for the public authorities in the form of a de facto waiver of public debts, exemption from the obligation to pay fines or other pecuniary penalties can constitute a State aid".

In paragraph 66 above mentioned, it is indicated that a measure that gives an advantage to certain undertakings involving an additional burden for the public authorities in the form of a State guarantee, a *de facto* waiver of public debts, exemption from the obligation to pay fines o other pecuniary penalties, or a reduced rate of tax, must be regarded as giving rise to the grant of State aid, within the meaning of Article 87 EC Treaty (Article 107 TFEU)[20]. Because those emission rights have a market value[21]: advantages granted for free directly or indirectly through State resources or constituting an additional charge for the State or for bodies designated or established by the State for that purpose can be sold, as they are tradable credits, and therefore have a market value.

As stated in the Judgment *Piaggio* of the Court of Justice of june the 17th of 1999, paragraph 43:

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[20] See, to that effect, Case C-295/97 *Piaggio* [1999] ECR I-3735, paragraphs 42 and 43. Judgement of the Court of Justice, 17th june 1999.

[21] S.WEISHAAR, The European emissions Trading system and State aid: an Assessment of the Grandfathering Allocation Method and the Performance Standard Rate System, ECLR 6/2007, pág. 374.

"In the light of the foregoing, it must be concluded that application to an undertaking of a system of the kind introduced by Law No 95/79, and derogating from the rules of ordinary law relating to insolvency, is to be regarded as giving rise to the grant of State aid, within the meaning of Article 92(1) of the Treaty, where it is established that the undertaking

- has been permitted to continue trading in circumstances in which it would not have been permitted to do so if the rules of ordinary law relating to insolvency had been applied, or
- has enjoyed one or more advantages, such as a State guarantee, a reduced rate of tax, exemption from the obligation to pay fines and other pecuniary penalties or *de facto* waiver of public debts wholly or in part, which could not have been claimed by another insolvent undertaking under the application of the rules of ordinary law relating to insolvency."

It is in the light of those principles that the Court must examine whether the measure in question confers on its beneficiaries an advantage financed through State resources.

In respect of the existence of an advantage financed through State resources the Kingdom of the Netherlands pointed out that he "does not directly grant emission allowances to the undertakings concerned, nor does it limit itself to imposing on them a binding emission standard". But, "it authorises the undertakings subject to that standard to trade between themselves the emission allowances which indirectly result from that standard, up to the limit of the ceiling applicable to each of them. By making those allowances tradable, the Kingdom of the Netherlands confers on them a market value. Any undertaking coming within the scheme may sell them at any time".

"Consequentely, the measure in question constitutes, in accordance with the case-law cited in paragraphs 63 to 66 above, an advantage granted to the undertakings concerned through State resources".

As to the selectivity criteria, the parties considered that the emissions trading scheme was not selective as the scheme was applied on the basis of an objective criterion. In fact, the scheme was based on the nitrous oxide national emissions ceiling for the Netherlands established by Directive 2001/81. Implementation of that ceiling was set out in Dutch legislation for

all industrial facilities with an installed thermal capacity of more than 20 MWth[22]. The undertaking could comply with the emissions standards by taking steps to reduce those emissions in its own facility or by buying emissions allowances from other undertakings (offered in the market by those facilities whose emissions fell below the emissions standard[23]), or by a combination of both. The involvement of the State was limited to setting the emissions standards and authorising trading.

Nevertheless, this argument was rejected by the Court of Justice the "contention contradicts the description of the measure in question. According to the description, the calculation of the emission standard provided for by the measure in question and the fines which are imposed when it is exceeded concern only the facilities covered by the scheme (see

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[22] Similarly, see, 2002/676/EC,ECSC: Commission Decision of 3 April 2002 on the dual-use exemption which the United Kingdom is planning to implement under the Climate Change Levy and the extended exemption for certain competing processes. The Commission believes that "dual-use exemption which the United Kingdom is planning to implement under the climate change levy, instituted by Section 30 and Schedules 6 and 7 of the United Kingdom Finance Act 2000, does not constitute aid within the meaning of Article 87(1) of the EC Treaty or point (c) of Article 4 of the ECSC Treaty. The exemption for less environmentally damaging processes, namely recycling production processes that compete directly with primary production processes falling within the scope of the non-fuel or dual-use exemption, constitutes State aid within the meaning of Article 87(1) of the Treaty. However, the aid meets the conditions for exemption under Article 87(3)(c) of the Treaty and is therefore compatible with the common market." (OJ 2002 L229/15).

The Commission found that regarding Case N 550/2000, Belgian Green Electricity Certificates, doesn´t constitute aid. It refers to a Rule of july the 17th 2000, regarding the organization of the electricity market, a several measures to stimulate the generation of electricity from renewable energy sources, adopted for a 10 years period. See OJ 2001 C-330/3.

[23] Case T-233/04; Judgment of the Court of First Instance, april the 10th 2008:

"10. In paragraph 1 of the contested decision, the Commission first describes the measure in question. In the framework of the NO_x national emission ceiling for the Netherlands established by Directive 2001/81, the Netherlands authorities set a target of 55 kilotonnes of NO_x emissions for its large industrial facilities, that is approximately 250 undertakings, to be attained by 2010.

11. Regarding the working of the scheme, the Commission explains in paragraph 1.2 of the contested decision that Netherlands legislation will lay down a NO_x emission standard for each industrial facility. The undertaking can comply with the emission standard thus laid down by taking steps to reduce NO_x emissions in its own facility, by buying emission allowances from other undertakings, or by a combination of those options. Emission reductions, in the form of NO_x credits, will be offered in the emission market by facilities whose emissions fall below the emission standard.

12. A facility's total annual NO_x emission, adjusted for any NO_x credits sold or bought, must comply with the authorised emission level for that facility. The authorised annual emission – as an absolute figure – is calculated on the basis of the emission standard concerned and the amount of energy used by that facility."

paragraphs 10 to 16 above)"[24]. Rather, "ecological considerations justify distinguishing undertakings which emit large quantities of NO_x from other undertakings (see, to that effect, *Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke*, cited in paragraph 80 above, paragraphs 49 and 52). The implementation of those principles must take into account Article 6 EC in conjunction with Article 87 EC"[25].

Having regard to the foregoing, the measure can not be considered as state aid. The Court considered that it was not necessary to rule on the second plea and therefore decided to annul the contested Decision as she understood that the aid was compatible:
the Court applied the traditional doctrine under which to understand that this is an advantage it is not necessary to disburse state funds but also simply lack of income in certain circumstances.
With those assets the Kingdom of the Netherlands put at the disposal of the undertakings concerned free of charge, he is conferring an advantage (§ 63-78). Moreover, such advantage was granted through State resources, as the allowances were put at the disposal of the undertakings concerned free of charge, whereas they could have been sold or put up for auction[26].

However, the matter regarding *Netherlands vs. Commission*, the Commission of the European Communities requested the Court to set aside the judgment of the Court of First Instance of the European Communities of 10 April 2008 in Case T-233/04 *Netherlands* v *Commission* by which the General Court annulled Commission Decision of 24 June 2003 on State aid N 35/2003 concerning the emission trading scheme for nitrogen oxides notified by the Kingdom of the Netherlands. The Kingdom of the Netherlands requests the Court to set aside the judgment under appeal to the extent that the first plea in law submitted by that State, concerning the absence of an advantage

[24] Case T-233/04; Judgment of the Court of First Instance, april the 10th 2008, § 91.

[25] Case T-233/04; Judgment of the Court of First Instance, april the 10th 2008, § 99.

[26] Case T-233/04; Judgment of the Court of First Instance, april the 10th 2008, § 75-76. As mentioned in the Order, this case was distinguishable from *Belgian Electricity Certificates*, where "the Commission had taken the view that that the green certificates provided only official proof of the production of the green electricity and that the State had therefore not agreed to forgo resources in providing them free of charge to the producers".

financed by State resources, is rejected. The Judgement, currently under appeal, Advocate General Mengozzi has endorsed the General Court´s approach on this point in his Opinion of December the 22nd of 2010[27]. Under this Opinion, it would seem that any emission trading scheme will involve -as a rule- conferral of an advantage from State resources provided that there is an option so that the *Belgian Electricity Green Certificates* will rarely apply. Following similar reasoning, the Commission has found that UK´s emissions trading scheme for carbon dioxide emissions linked to energy consumption conferred an advantage, as revenues paid for permits were in part recycled back to these undertakings as subsidies[28].

"26. However the Commission appealed the NOx judgement of the Court and is of the opinion hat the advantage involved in this trading scheme and the advantage involved in the related recycling mechanism is a positive benefit which by its nature cannot be non selective because only some companies can benefit from it. In addition, regardless of the outcome of the appeal to the European Court of Justice, the Commission considers that it will not have an impact on the assessment of the existence of aid in the case at hand because the scheme involves in any event selective advantage involved in the payments which the best performing companies receive above what they pay for allowances".

V. To what extend allowances granted by Member States under EU ´s ETS may be considered selective?

The first question that arise is whether undertakings within or without the EU ETS to be considered "in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question" as mentioned in the Decisions and Judgments ment before. The answer to that question can only be one: no. Non-ETS undertakings and ETS undertakings are not comparable; the first ones, are subject to a special regime as a market price is placed on their pollution; on the contrary, non-

[27] Available at: http://curia.europa.eu/juris/liste.jsf?num=C-279/08&language=en.

[28] Case N629/2008, see Commission letter Brussels, 13.7.2009 (C(2009) 5523 final).

ETS undertakings, don´t have such a price placed on their polluting activities[29].

In *Danish CO2 Refund,* the Commission agreed with this view, taking into account that the scheme proposed to refund all or part of the Danish carbon dioxide tax in the case of EU ETS undertakings constituted State Aid[30]:

> "The Danish authorities argue that the proposed tax relief does not confer a selective advantage on the beneficiaries, since it covers all undertakings that are legally and factually in the same situation, namely those who are the subject of double regulation. Should it be assumed, however, that it is a case of selective advantage, the Danish authorities find this justified by the nature and structure of the system. This is because the CO2 tax and the EU ETS have the same objective, i.e. to reduce CO2 emissions. Since the EU ETS was introduced the CO2 tax no longer serves any environmental purpose. For companies covered by the EU ETS, the CO2 tax is therefore not an effective instrument for reducing the overall CO2 emissions, but merely an extra economic burden."

"The Commission notes that it was established in the *Adria-Wien* judgment[31] that 'the only question to be determined is whether, under a particular statutory scheme, a State measure is such as to favour certain undertakings or the production of certain goods within the meaning of Article 92(1) of the Treaty in comparison with other undertakings which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question'. There is recent case-law[32] on the interpretation of advantage and selectivity. The Gibraltar[33] judgment offered a standard State aid analysis for tax cases. The Court of First Instance held that such an analysis should consist of: (1) the identification of the system of reference;

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[29] A.T. SEINEN, State aid aspects of the EU Emission Trading Scheme: the second trading period, Competition Policy Newsletter, 3, 2007,100.

[30] Commission Decision of 17th June 2009 on aid scheme 41/06 (ex N 318/A/04) which Denmark is planning to implement for refunding the CO2 tax on quota-regulated fuel consumption in industry *(notified under document C(2009) 4517)*, OJ 2009 L345/18.

[31] November 2001 in Case C-143/99, Adria-Wien Pipeline and Wietersdorfer &Peggauer Zementwerke v Finanzlandesdirektion für Kärnten [2001] ECRI-8365.

[32] Judgment by the Court of First Instance of 10 April 2008 in CaseT-233/04, *Netherlands* v *Commission* ('the NOx-judgment'), [2008]ECR II-591, judgment of 22 December 2008 in Case C-487/06 P, *the British Aggregates Association* v *Commission*.

[33] Judgment of 18 December 2008 in joined Cases T-211/04 andT-215/04, *Gibraltar* v *Commission*.

(2) the determination of the derogation from that system of reference; and (3) the possibility of justification of the derogation by the nature or structure of the system."

The result was that the measures could not be view as constituting the reference system for assessing whether undertakings were treated in a similar manner and therefore the exemption was not justified by the nature and logic of the tax system[34]. Some authors have criticized the Commission conclusion regarding the possibility that the EU ETS have as its goal the collection of revenue. In fact, they consider that there is a contradiction between this reasoning and the EU ETS Directive. Under the Directive, substantial revenue derives from auctioning[35].

The second question that arise regards the possibility for Member States to distinguish between undertakings on the basis of other criteria, such as sector, or others.

VI. Exemption for environmental aid: article 107 (3) TFEU.

Currently, 2008 *Community Guidelines on State Aid for Environmental Protection*[36], recognises that tradable permit schemes may involve aid in different ways setting out two methods of State aid assesment for tradable permits. Guidelines set the limits and conditions for the free allocation of allowances to be classified as State aid compatible with Community competition law. The premise of the Guidelines seem to be that all Phase II allowances constitute State Aid.

In fact, some of the factors stated in article 107 (3) c) TFEU are fundamental in order to assess selectivity. As regards Phase I and in order to fall under article 107(3) c) TFEU, the Guidelines state that Member State allocation of

[34] Decision of 17th June 2009, §45.

[35] Article 10 (3) EU ETS states that: "Member States shall determine the use of revenues generated from the auctioning of allowances. At least 50 % of the revenues generated from the auctioning of allowances referred to in paragraph 2, including all revenues from the auctioning referred to in paragraph 2, points (b) and (c), other equivalent in financial value of these revenues, should be used".

[36] 2008/C 82/01, OJ C82, 1st April 2008.

allowances must be carried out in a transparent way[37], based on objective criteria and not favour certain undertakings or certain sectors unless this is justified by the environmental goals or policies themselves, as established in criterion five Annex III Directive 2003/87/EC: "The plan shall not discriminate between companies or sectors in such a way as to unduly favour certain undertakings or activities in accordance with the requirements of the Treaty, in particular Articles 87 and 88 thereof". This concords with the allocation criteria set out in the Directive itself and with the Commission approach. In that sense, the Order of the Court of Justice of 30rd of april 2007 (case T-387/04), discussed in detail above, Commission letter confirming that German Phase I NAP probably would be compatible with State Aids under Article 108 (3) TFEU. Similarly and regarding Phase II, we find the same criteria: transparency, objectivity and no discrimination which are all elements that form part of the selectivity analysis. If those criteria are fulfilled, aid can not be considered as selective. Taking into account this Commission´s approach, it seems that it is always necessary an analysis that combines article 107(1) and 107 (3) TFEU. In that sense, and regarding allowances in Phase I and II, the distinction between both paragraphs of article 107 TFEU is relevant due to the difference about the burden of proof: elements of article 107 (1) TFUE must be proved by the Commission and elements of article 107(3) TFEU by Member States. In Phase III, the State Aid rules will apply occasionally, where allowances are not allocated neither by auction nor to the Commission´s harmonised allocation rules.

Two further elements must be taken into account in analysing state aid: distortion of competition and effect on trade between Member States. In doing so, *de minimis* thresholds and rules must be considerate (Commission Regulation EN núm. 1998/2006 of 15 December 2006 on the application of articles 87 and 88 of the Treaty to *de minimis* aid[38]). That is, distortion on competition must be limited so the overall balance has to be positive[39]. "(36)

[37] See I. FERNÁNDEZ and M.D. UTRILLA, "The allocation of limited authorisations in Spain: considerations from the analysis of three specific sectors", in this book.

[38] OJ 2006, L379/5.

[39] The 2008 Guidelines,§ 32: "The Commission should review the functioning of Directive 2003/87/EC in relation to aviation activities in the light of experience of its application and should then report to the European Parliament and the Council."

If environmental State aid measures are well targeted to counterweigh only the actual extra costs linked to a higher level of environmental protection, the risk that the aid will unduly distort competition is normally rather limited. Consequently, it is crucial that environmental State aid measures are well targeted. In cases where aid is not necessary or proportionate to achieve its intended objective it will harm competition. This may in particular be the case if aid leads to:

a) maintaining inefficient firms afloat;

b) distorting dynamic incentives/crowding out;

c) creating market power or exclusionary practices;

d) artificially altering trade flows or the location of production."[40]

The *2008 Guidelines* take into account a very economic approach as we have already mentioned. We can make two relevant considerations regarding those Guidelines: 1) Member State aid can play an important role in achieving environmental goals and 2) it is important to achieve integration between EU Members for the environmental policies. Let´s see what the Commission´s approach to environmental aid is.

The first method relates to the EU´s ETS scheme up to 2012. In this case, in order to limit the distortion of competition, no over allocation is permitted nor provisions can not create undue barriers to entry.

First of all, it seems that aid should be exempted if it incentives pollution reduction or if it creates other incentives to achieve a higher level environmental protection as stated in 2008 Guidelines: "The primary objective of State aid control in the field of environmental protection is to

[40] The 2008 Guidelines, §36: "In particular, the Commission should be empowered to adopt measures for the auctioning of allowances not required to be issued for free; to adopt detailed rules on the operation of the special reserve for certain aircraft operators and on the procedures relating to requests for the Commission to decide on the imposition of an operating ban on an aircraft operator; and to amend the aviation activities listed in Annex I where a third country introduces measures to reduce the climate change impact of aviation. Since those measures are of general scope and are designed to amend non-essential elements of this Directive, *inter alia*, by supplementing this Directive with new non-essential elements, they must be adopted in accordance with the regulatory procedure with scrutiny provided for in Article 5a of Decision 1999/468/EC."

ensure that State aid measures will result in a higher level of environmental protection than would occur without the aid and to ensure that the positive effects of the aid outweigh its negative effects in terms of distortions of competition, taking account of the polluter pays principle (hereafter "PPP") established by Article 174 of the EC Treaty" (paragraph 6).

Thus, when the assignment is below market value (which is always assumed that there is free allocation) it is State aid. However, there may be reasons to make convenient the existence of such aid: it can be used to target negative externalities by introducing market-based instruments for environmental objectives but can never assume all the needs of the facility, and companies must reduce their pollution or buy more rights on the market.

There is no chance or marge for over-allocation to one or more facilities. Thus, to the extent that they contribute to the internalization of the damage caused by greenhouse gases, and in accordance with the principle "polluter pays" they may never get to meet the total needs of the facility because then there would be no internalization but would the community assume the entire cost of pollution.

"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. This type of aid may be used to target negative externalities by allowing market-based instruments targeting environmental objectives to be introduced. If the global amount of permits granted by the Member State is lower than the global expected needs of undertakings, the overall effect on the level of environmental protection will be positive. At the individual level of each undertaking, if the allowances granted do not cover the totality of expected needs of the undertaking, the undertaking must either reduce its pollution, thus contributing to the improvement of the level of environmental protection, or buy supplementary allowances on the market, thus paying a compensation for its pollution. To limit the distortion of competition, no over-allocation of allowances can be justified and provision must be made to avoid undue barriers to entry." (§55 *2008 Community Guidelines*).

In short, free allocation of allowances is only admissible if it is lower than the needs of the facilities because this way they are forced to reduce emissions or buy more allowances on the market. Thus, over-allocation constitute a prohibited aid.

Once these general criteria of admissibility of aid are fixed, the Guidelines determine the specific criteria to allow the Commission to declare aid compatible with European law that is, *the balancing test*. As Paragraph 16 of the 2008 Guidelines state: "In assessing whether an aid measure can be deemed compatible with the common market, the Commission balances the positive impact of the aid measure in reaching an objective of common interest against its potentially negative side effects, such as distortion of trade and competition. The State Aid Action Plan, building on existing practice, has formalised this balancing exercise in what has been termed a "balancing test". It operates in three steps; the first two steps address the positive effects of the State aid and the third addresses the negative effects and resulting balancing of the positive and negative effects".
State aid may be declared compatible with the common market (Art. 107.3 TFEU) if provisions of article 140 a)-d) of the 2008 Guidelines fulfillment of the provisions of art. 140 a)-d) of the Community Guidelines 2008 are fulfilled.

The tradable permit schemes must be set up in such a way as to achieve environmental objectives beyond those intended to be achieved on the basis of Community standards that are mandatory for the undertakings concerned. The aid must be designed to "deliver the objective of common interest" which includes protection of the environment. Aid must be an appropriate policy instrument ("State aid for environmental protection must result in the recipient of the aid changing its behaviour so that the level of environmental protection will be higher than if the aid had not been granted", § 27). It is also required that the objective is not attainable without the aid and that has led to the doctrine of eligible costs[41], this means that only costs exceeding

[41] S. KINGSTON, Greening EU Competition Law and Policy, 408.

the benefits an undertaking receives for its investments can be exempted. Further more, to be proportionate aid must be inferior than the eligible test[42]. the allocation must be carried out in a transparent way, based on objective criteria and on data sources of the highest quality available.
the allocation methodology must not be selective.
new entrants shall not in principle receive permits or allowances on more favourable conditions than existing undertakings operating on the same markets[43].

The Commission will apply those criteria taking into account the rules set out in the ETS Directive and in the different Communication documents.

The second method of assesments refers to post-2012 ETS period and national tradable permit schemes. The criteria that the Commission will use refers to measures that are necessary and proportional.
Paragraph 56 of 2008 Community Guidelines, state that: "The criteria set out in point 55 from the basis for the Commission's assessment of situations arising during the trad- ing period ending on 31 December 2012. With respect to situations arising during the trading period after that date, the Commission will assess the measures according to whether they are both

[42] Guidelines 2008, (32)" However, it is difficult to fully take into account all economic benefits which a company will derive from an additional investment. For example, according to the methodology for calculating eligible costs set out in points 80 to 84, operating benefits are not taken into account beyond a certain initial period following the investment. Likewise, certain kinds of benefits which are not always easy to measure — such as the "green image" enhanced by an environmental investment — are not taken into account in this context either. Consequently, in order for the aid to be proportionate, the Commission considers that the aid amount must normally be less than the eligible investment costs, see Annex. It is only in cases where investment aid is granted in a genuinely competitive bidding process on the basis of clear, transparent and non discriminatory criteria — effectively ensuring that the aid is limited to the minimum necessary for achieving the environmental gain — that the aid amount may reach 100 % of the eligible investment cost. This is because under such circumstances it can be assumed that the respective bids reflect all possible benefits that might flow from the additional investment."

[43] See Decision 653/99, 29th march 2000, CO2 quotas- Denmark (Bruxelles, den 12.04.2000 SG(2000) 508). In relation to this Decision, the Danish authorities will ensure that if there are new entrants on the Danish electricity market during the operation of the scheme, these will receive quotas based on criteria that are objective and non-discriminatory in relation to those applied to incumbent producers. The criteria are subject to approval by the Commission. Precisely it is stated in that Decision that: "New entrants on the market after the introduction of the system will receive emission permits based on non-discriminatory criteria".

necessary and proportional. Finally, this will inform the revision of these Guidelines taking into account, in particular, the new Directive on the EU CO2 Emission Trading System, for the trading period after 31 December 2012".

In particular, paragraph 141 of the 2008 Community Guidelines, state that:

"The Commission will assess the necessity and proportionality of State aid involved in a tradable permit scheme according to the following criteria:

the choice of beneficiaries must be based on objective and transparent criteria, and the aid must be granted in principle in the same way for all competitors in the same sector/relevant market if they are in a similar factual situation;

full auctioning must lead to a substantial increase in production costs for each sector or category of individual beneficiaries;

the substantial increase in production costs cannot be passed on to customers without leading to important sales reductions. This analysis may be conducted on the basis of estimations of inter alia the product price elasticity of the sector concerned. These estimations will be made in the relevant geographic market. To evaluate whether the cost increase from the tradable permit scheme cannot be passed on to customers, estimates of lost sales as well as their impact on the profitability of the company may be used;

it is not possible for individual undertakings in the sector to reduce emission levels in order to make the price of the certificates bearable. Irreducible consumption may be demonstrated by providing the emission levels derived from best performing technique in the European Economic Area (hereafter 'EEA') and using it as a benchmark. Any undertaking reaching the best performing technique can benefit at most from an allowance corresponding to the increase in production cost from the tradable permit scheme using the best performing technique, and which cannot be passed on to customers. Any undertaking having a worse environmental performance shall benefit from a lower allowance, proportionate to its environmental performance."

Polluter Pays principle is the key for this period as there will be less space for State aid. Regarding National Trade Schemes the Commission

understood that UK´s emissions trading scheme did not fall under the 2008 Guidelines and was compatible the EU State rules on the basis of article 107(3) (c) TFEU[44] (similarly in case: Danish CO2 Rebates as the Commission took inspiration from the criteria set out herein[45]).

As for Spain, the case law of the Supreme Court[46] reveals that the main failure on the implementation of the system in Spain has been the lack of motivation: in a number of judgments the Court has annulled individual assignments because the Council of Ministers did not make explicit the reasons for the allocation of a certain amount of rights; so, among others, the judgments of 23 and 24 September 2008, 9-14-20 July 2010, 8 October 2010, 16 November 2010, 28 December 2010 and 25 January 2011. As stated by the Supreme Court in its Judgment of 29 May 2009, both Plans and individual allocations must be properly motivated, being the requirement of motivation applicable with respect to the two phases of assignments in accordance with EU law. Some of the Supreme Court Decisions refers to

[44] Case 629/2008, *Carbon Reduction Commitment*: "35. The scheme is designed and its modalities are directly and exclusively aimed at protecting environment through the re distribution of resources in favour of undertakings which protect the environment the most. The revenue is recycled back to participants not to provide allowances for free or to purely compensate for the cost of allowances, but as a key driver for high performance within the scheme, and thus greater energy efficiency. The payments out of the Recycle Fund are therefore an additional mechanism within the trading system to enhance environmental performance. The grant is bound to the speed and extent of the emissions reduction and the performance league table and has clearly environmental objectives. In particular the existence of the Recycling Fund and the related non- financial incentives will allow the UK authorities to determine a stricter cap, thereby obtaining a larger reduction of emissions. Such reduction is possible because the organizations covered by the CRC normally would disregard costs signals of a stricter cap without recycling and may well prefer to rely on the option to buy AAs rather than reducing their own emissions. Although the Recycle Fund is a refund mechanism where all revenues are redistributed to all participants of the CRC scheme, its distribution – and thereby economic effect – is purely dependent on the objective environmental performance of the participating companies.

36. It follows from the above that the scheme is based on competitive behaviour between undertakings aiming solely at protection of environment. Such an innovative, purely national scheme, was not foreseen at the time of drafting the Guidelines."

[45] Commission Decision of 17th June 2009, case C41/06. The Commission concluded that: "(67) the proposed scheme 'Modification of the CO2 tax on quota-regulated fuel consumption in industry' constitutes State aid within the meaning of Article 87(1) of the EC Treaty; (68) Provided that all beneficiaries still pay a tax on each energy source which respects the Community minimum tax levels, the aid is declared compatible with Article 87(3)(c) of the EC Treaty."

[46] M.C. ALONSO GARCÍA, "El nuevo régimen jurídico del mercado europeo de derechos de emisión de gases de efecto invernadero", Actualidad Administrativa, 2012, forthcoming.

mistakes in the calculation of the allocation of allowances: 30 September 2008, 1 and 6 October 2008, 3 December 2008, 8 April 2009 and 26 January 2011. Finally, some Decisions refer to the increasing capacity of the undertakings and overallocation of allowances: 27 November 2008, 1-2 and 3 December 2008 and 29 May 2009.

VII. Some brief remarks about Allocation of aviation allowances in a wide ETS and the role of competition.

From 2012 the EU ETS will also include CO2 emissions from civil aviation. This means airlines of all nationalities will need allowances to cover the emissions from their flights to, from or within the EU. Using emissions trading to tackle the fast-growing emissions from the aviation sector is fully in International Civil Aviation Organization. In order to mitigate the climate impacts of aviation, the EU has decided to impose a cap on CO_2 emissions from all international flights – from or to anywhere in the world – that arrive at or depart from an EU airport.

However, and although, airlines seemed to accept that their inclusion in the CDE was necessary for its contribution to addressing climate change, the worsening of conditions in which this system will be applied during the legislative process - with increasing percentage of auctions of emissions and the reduction of average emissions were then determined, and the new context of recession, raised the criticism of the major actors of air transport. According to the airlines, there has been no serious impact study on the emissions auction to support these percentages and, therefore, not been assessed its effect on an industry that is mired in a serious economic crisis

It is true that the system can turn into a new source of costs for European airlines.

Furthermore, some aspects of the system, such as trade undergoing the emissions at present, with a similar functioning as living oil. This would, for airlines, a new variable fluctuable that could endanger their growth.

The EU ETS will cover any aircraft operator, whether EU- or foreign-based, operating international flights on routes to, from or between EU airports. All

airlines will thus be treated equally. Very light aircraft will not be covered. Military, police, customs and rescue flights, flights on state and government business, and training or testing flights will also be exempted. Legality of EU ETS was subject to extensive consideration during development of the legislation. Court case by US Airlines at European Court of Justice on the 21 December 2011, the European Court of Justice delivered its judgment in a legal case brought by some US and Canadian airlines and their trade association against the inclusion of aviation in the EU ETS.

In principle, this model implies a strong restriction on flights to insular and outermost regions, to which access, this is almost the only way of transportation (or at least there are not comparable). The issue is complicated in these cases because it is common that operators receive public aid as compensation for public service obligations. Under terms of that section of the Directive, the flights operated under public service obligations should be excluded. This aspect should be analyse under the new rules.

But the main problem we see regarding competition refers to the fact that free allowances can be considered as state aid. The EC has admitted the possibility that the free allocation of allowances by the EM concealed aid and prove that this aid is contrary to the provisions of Articles 107 and 108 EFFT. The Community guidelines on State aid for environmental protection (2008/C82/01) OJ series C, April 1, 2008, establish the limits and conditions for the free allocation of allowances to be classified as State aid compatible with the EC Treaty. When the assignment is below market value (which means that whenever there is free allocation) is public support.