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Hand-on experience: Legal challenges and their implications to ETS Law (EU/Germany)

“Sharing Experiences on Developing Emissions Trading System (ETS) Law”
Bangkok 8 – 9 November 2018

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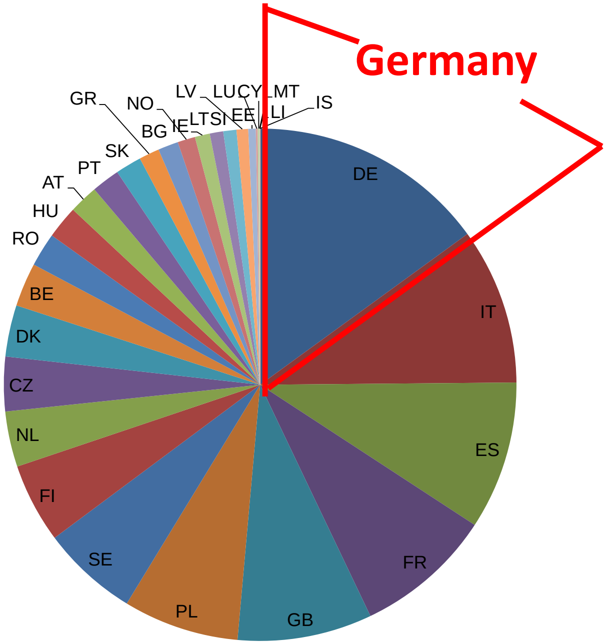
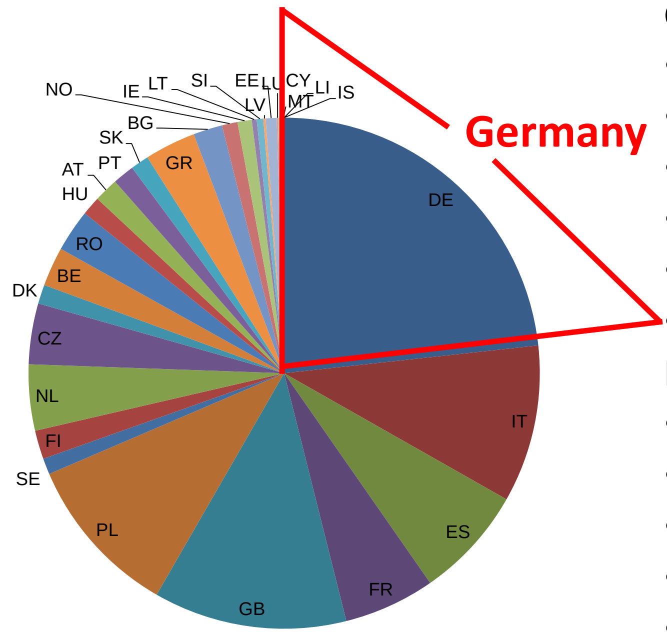
EU ETS Overview

Number of installations



Emissions



Current key figures - 2017:

Germany:

- 1,833 installations
- 438 million t CO_{2e}
- 3,4 % < 2016
- 72 aircraft operators
- 9.1 million t CO_{2e}
- 1.8 % < 2016

Europe:

- 11,781 installations
- 1.75 billion t CO_{2e}
- 0,2 % > 2016
- > 40 % of EU GHG
- 511 aircraft operators
- 64 million t CO_{2e}
- 4.5 % > 2016

Source: EEA, Trends and projections in the EU ETS 2017
UBA/DEHSt, VET Bericht 2017

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Outline

- **Legal Framework & Specification**
- **Legal Cases – Key Judgements of European and German Courts**
  - Legality of the Establishment of the ETS in Germany
  - Scope and Competitiveness Aspects
  - Phasing-in Auctioning
  - Sanction Mechanism:
    - „Excess Emissions Penalty“ I
    - „Excess Emissions Penalty“ II

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Framework and Specification

- **Establishing** an **ETS** requires a **sound legal framework** to…
  - Ensure the environmental integrity of the scheme
  - Avoid negative impacts, e.g. distortions of competition

- Required **level and grade of regulation depends on constitutional & legal system** of each jurisdiction; **in general:**
  - **Major ETS design decisions & main principles** shall be laid down in a **high-level legislative framework**
    => Providing legal certainty for the scheme
  - **Implementation details** set out in **subordinate legislation**
    => Assuring flexibility in the market design

EU-ETS and Lawsuits

- **High willingness for litigation**, especially in Germany
- Possible reasons:
  - “Continuation of policy-making with other means“
  - Distributional conflict, individual justice and equality: specific allocation rules might lead to different treatment between operators
  - Duty to go to court is often obligatory because of management liability rules
- Contribution to the evolution of the EU ETS

Legality of the ETS
Facts I

- **EU ETS framework** established by European **Emissions Trading Directive 2003/87/EC (ETD)** in 2003**; Phase I 2005-2007; key requirements and obligations**
  - **Greenhouse Gas Emissions Permit** & approved **Monitoring Plan (MP)**
  - **Monitoring & reporting** of annual emissions
  - **Submitting** a (verified) **Annual Emissions Report (AER)** regarding the previous year **by 31 March**
  - **Surrendering allowances** to **cover** the **emissions**
- **ETD transposed** into nationaly law by **Greenhouse Gas Emissions Trading Act (**Treibhausgas-Emissionshandelsgesetz) in 2004

Legality of the ETS
Facts II

- **Operators** of installations covered by the EU ETS **challenged the new requirements/obligations**

- **Companies claimed** new **obligations** would **infringe fundamental rights** (e.g. **property**):
  - Construction and operation of an **installation** that could have a **harmful impact on the environment** (e.g. pollution, noise etc.) is subject to a **permit** requirement under **Federal Immission Control Act**
  - By **obtaining this permit** before a **legitimate expectation was created**

Legality of the ETS
Judgement

- **Federal Administrative Court of Germany** decided in **2005**:

  Implementation of the **ETS and its obligations do not constitute a violation of fundamental rights** of operators of incumbent installations

- **Reasons:**
  - **ETS obligations** have to be seen **separately from the obligations under the Immissions Control Act**
  - **Existing permit** refers to non-GHG emissions and **doesn't grant a right to unlimited emissions,** operators' **obligations** are **"dynamic"**
  - **CO_2 emissions of an installation** are **not prohibited but regulated** in an required and proportionate way

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Scope & Competitiveness
Facts I

Gases

Initially, the EU ETS focused on CO_2
N_2O and PFCs were added in phase III.

Point of regulation

Downstream

Sectors

Energy: Power and heat generation
Industry: Energy-intensive sectors incl. oil refineries, iron and steel, aluminium, metals, cement, lime, glass, ceramics, pulp, paper, cardboard, acids, and bulk organic chemicals
Aviation

Thresholds

Energy: > 20 MW total rated thermal input
Industry: Varying thresholds for different sectors; Small installations with fewer than 25,000 tons of CO_2e may be excluded
Aviation: 10,000t CO_2 /year

EU ETS: 11,800 installations & 40 % GHG emissions.

Scope & Competitiveness
Facts II

- Production of **steel** has been **covered** by the **EU ETS** since **Phase I**

- Production of **aluminium** and **plastics (chemical industry) had been excluded initially**

- **Steel industry challenged** this claiming:
  - **Non-ferrous metals** and **plastics** are not subject to ETS obligations
  - Products of this sectors may serve as **substitutes to steel** although the **production processes** lead to greenhouse gas **emissions as well**
  - This leads to a **distortion of competition** and constitutes a **breach of the principle of equal treatment**

Scope & Competitiveness
Judgement

- **ECJ (European Court of Justice) decided in 2008:**

  The Emissions Trading Directives' approach to **exempt certain sectors from the scope does not violate the principle of equal treatment**.

- **Reasons:**
  - **Steel, non-ferrous metals** and **chemical sectors** are in a **comparable position** regarding the aim of the ETS while beeing **treated differently**
  - In general, all **relevant competitors have to be covered** by ETS to **avoid unjust market distortions**
  - However, a **"step-by-step approach"** to enlarge the ETS scope is **reasonable and justified**

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Phasing-in Auctioning
Facts I

- **ETD 2003/87/EC** stipulated that Member States have to **allocate allowances in Phase I and II mainly free of charge :**
  - Phase I: 95 %
  - Phase II: 90 %

- **Phase I Germany:**
  - **100 % free of charge** (grandfathering, benchmarking)
  - Liberalised **electricity market** with **very low level of competition**
  - **Windfall profits** for **electricity** producers **passing through** the **(opportunity) costs**

Phasing-in Auctioning
Facts II

- **Phase II Germany** to **phase-in auctioning**
  - **40 Mt CO_2** (8 % of the cap) **have been auctioned per year**
  - **Allocation** for electricity producers was **determined based on benchmarking**
    - 750 g CO_2 per kWh for solid fuels
    - 365 g CO_2 per kWh for gaseous/liquid fuels
  - **Allocation** amount of **each power producer** has been **reduced by 15 %** to be auctioned instead

- **Power sector challenged** the **the auctioning approach claiming**
  - State is **not allowed** to **auction the „use of air/atmosphere“** and **violates fundamental rights**

Phasing-in Auctioning
Judgement

- **Federal Administrative Court of Germany** decided in **2012**

  Phasing-in auctioning of allowances for electricity producers is proportionate and therefore justified.

- **Reasons:**
  - **ETS** aims at putting a **price on CO_2** ;to the **disadvantage** of **CO_2-intensive** technologies and to **incentivise low carbon technologies**; **auctioning** is an **efficient** way of carbon pricing
  - **Fundamental rights** of operators have **to be taken into account phasing out** free **allocation**, but **operators** who **pass through CO_2** costs **do not need an allocation free of costs**

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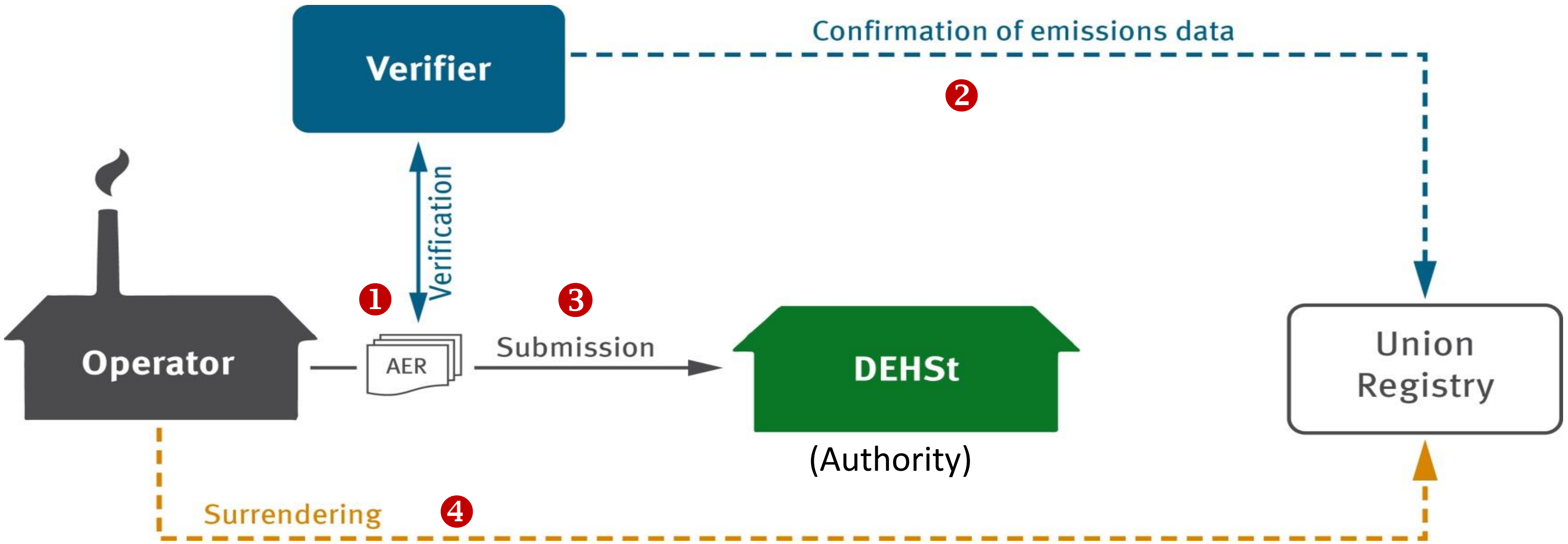
Excess Emissions Penalty I
Facts I



- **Operator** drafts the **Annual Emissions Report (AER); verifier ❶** verifies the AER and issues a Verification Report (VR)
- **Verifier ❷ confirms** the total amount of CO_2e emissions in the Union Registry (VET – Verified Emissions Table),
- **Operator ❸ submits** verified **AER to** the **Authority** by 31st March
- **Operator ❹ surrenders allowances** by 30th April

Excess Emissions Penalty I
Facts II

- **Art. 12 (3) ETD 2003/87/EC**

  *"… **by 30 April each year** at the latest, the **operator** of each installation **surrenders a number of allowances (…) equal to** the total **emissions** from that installation **during the preceding calendar year** as verified in accordance with Article 15…"*

- **Art. 16 (3) ETD 2003/87/EC**

  *"…operator who **does not surrender sufficient allowances by 30 April to cover its emissions** during the preceding year **shall be held liable for the payment of an excess emissions penalty**. The excess emissions penalty shall be **EUR 100 for each tonne** of carbon dioxide equivalent emitted for which the operator or aircraft operator has not surrendered allowances. (…)"*

  - Phase I: 40 €
  - Payment **doesn't release operator** from the surrender obligation

Excess Emissions Penalty I
Facts III

- **Two installations** which **didn't surrender allowances at all** by 30 April 2007 to cover the emissions of 2006 (10,000 t & 42,000 t)
- Swedish Environment Protection **Agency imposed the penalties** (EUR 433,120 & EUR 1,697,320)

- **Companies challenged the Penalty claiming they**
  - **Didn't want to circumvent** the surrender **obligation**
  - Had **sufficient allowances on** their registry **accounts** but missed the deadline due to **internal administrative breakdown**

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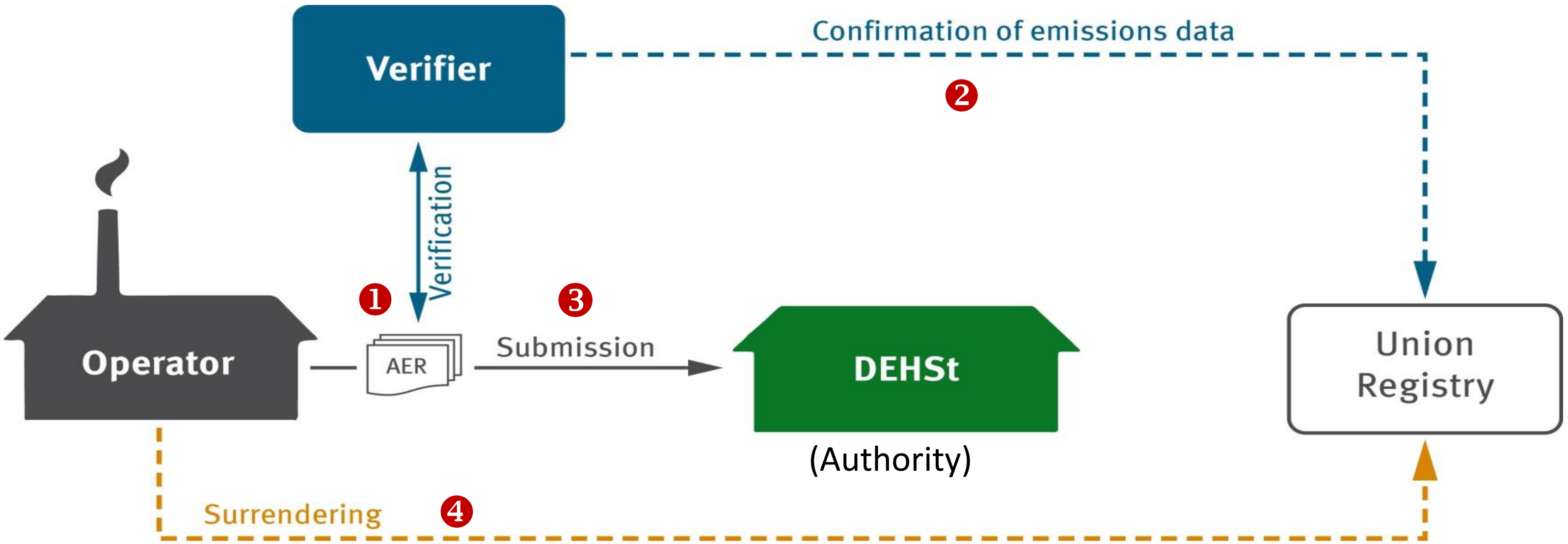
Excess Emissions Penalty I
Judgement

- **European Court of Justice decided in 2013:**

  The **"excess emissions penalty"** regarding the failure to surrender allowances to cover the emission of the preceding year is **justified**, **irrespective of the reason for the non-surrender.**

- **Reasons:**
  - **Obligation to surrender** allowances plays a **key role** in the **ETS** and for the **integrity** of the instrument
  - "Excess Emissions" are all emission not covered by an surrendered allowance by 30 April
  - However, "force majeure" making it objectively impossible to comply with the obligation would have to be recognized

Excess Emissions Penalty II
Facts I



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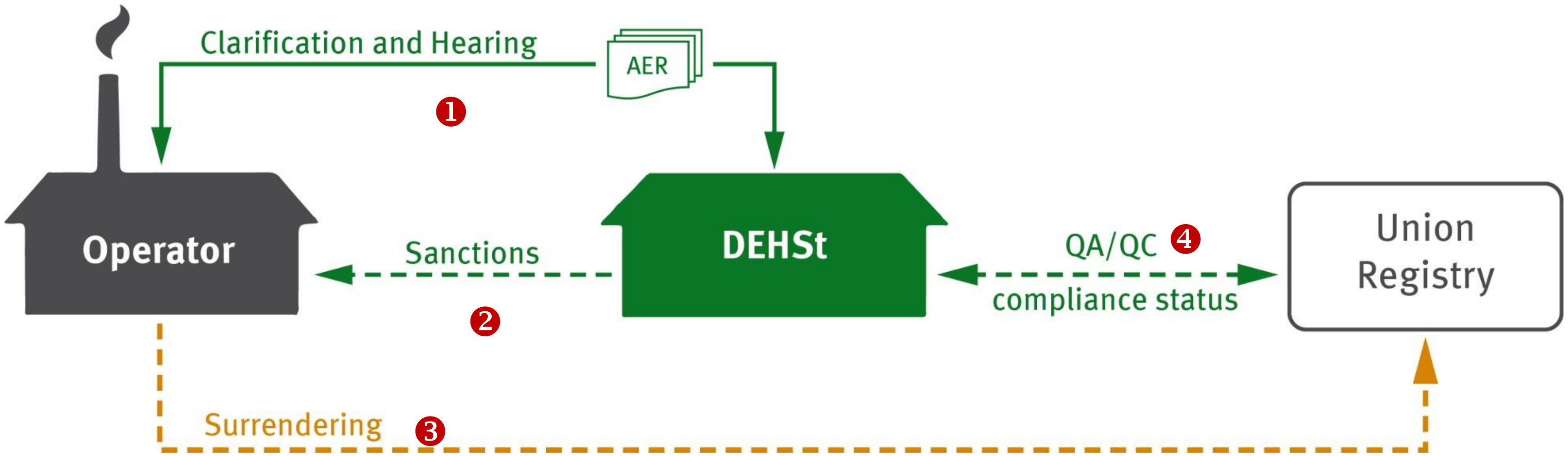
Excess Emissions Penalty II
Facts II



- **CA checks AERs** and ❶ **asks for clarification**, if required
- If emissions were underestimated the **CA** ❷ **may estimate the additional amount of emissions** for the reporting year; **operator may be fined; Excess Emissions Penalty also for reporting mistakes detected after 30 April?**
- **Operators** ❸ have to **surrender additional allowances**; **CA** ❹ checks the **compliance status**

Excess Emissions Penalty II
Facts III

- In **Germany** the **Excess Emissions Penalty** has **also** been applied on **reporting mistakes**
- If the **authority detected** that the **total verified emissions** have been **understated** operators had to pay the penalty

- **Various companies challenged this practice claiming**
  - Sanctioning practice in Germany is **disproportionate** because it is **imposed regardless of negligence or fault**
  - **Meeting the deadline** for surrender might be **simple, avoiding** reporting **mistakes** is considerably more **difficult**
  - Surrender **obligation** is **determined by the** emissions stated in the independently **verified report**

Excess Emissions Penalty II
Facts IV

- **Art. 12 (3) ETD 2003/87/EC**

  *"… **by 30 April each year** at the latest, the **operator** of each installation <u>**surrenders**</u> **a number of <u>allowances</u> (…) <u>equal to</u>** the <u>**total emissions**</u> from that installation during the preceding calendar year <u>**as verified in accordance**</u> with Article 15…"*

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Excess Emissions Penalty II
Judgement

- **European Court of Justice decided in 2015:**

  The **“excess emissions penalty”** is **precluded if** the allowances surrendered **equal the verified emissions** of the reporting period.

- **Reasons:**
  - **Surrendering allowances** one of the **key obligations**
  - **Emissions Trading Directive refers** to the **verified emissions**
  - To apply the **“excess emissions penalty” on reporting mistakes** is **disproportionate** as it **doesn’t take into account the reason** for the misreporting
  - However, a **fault based sanctioning system should be established** by Member States **for cases of understated emissions**

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Thank you for your attention

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B A C K U P

Establishing an ETS
Pilot Phase - Learning by Doing

Learning is possible only in a "real" system

- **"Hard" Framework**
  - Duties of covered installations and sanctions need to **ensure compliance**
  - **Verified data** ensure information basis for subsequent more ambitious trading periods
- **Soft Start**
  - Generous cap providing for **manageable reduction efforts**
  - **Cost free allocation** & **Phasing-in Auctioning**
  - **Additional policies** can reconcile economic impacts (e.g. by developing renewable energy, improving energy efficiency, solutions for carbon leakage)

EU ETS
Institutional Framework
Institutional Capacity Needs for an ETS

Tasks	Relevant Institutions
Setting cap and scope	**Government**
Implementing Allocation	**Competent Authority (CA):** centralized or regional
Monitoring Reporting Verification	**Operator / Verifier** Operator’s report is checked by independent 3rd party → **CA** makes overall check of compliance
Approval of Verifiers	**Accreditation Body**
Surrendering of Allowances Sanctions	**CA** receives allowances and imposes sanctions in case of non-compliance

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EU ETS
Institutional Framework

Federal Ministry of Environment

Political oversight

- Formulation of laws and regulations
- Coordination with other Ministries
- Cooperation with interest groups and stakeholders
- Communication with the EU COM and participation in EU Working Groups and Climate Change Committee
- Supervising the Competent Authority
- International cooperation to build up national and regional ETS

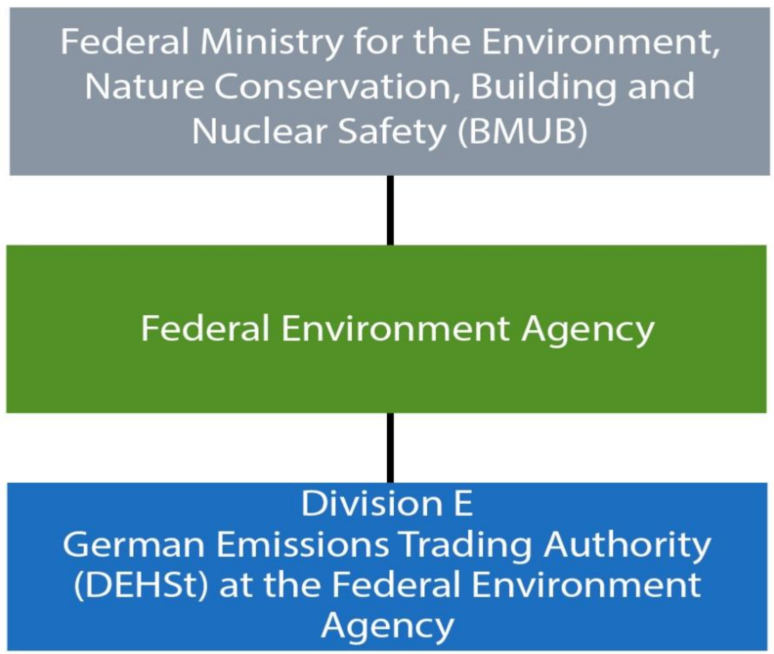
Competent Authority (DEHSt)

Technical ETS implementation in Germany

- Allocation and issuance of emission allowances
- Approval of monitoring plans
- Assessment of emission reports, imposing of sanctions where applicable
- Management of national installations and trading accounts
- Supervision of auctioning
- Approval and review of CDM and JI projects

EU ETS
Institutional Framework

Structure of the German administration on the federal level



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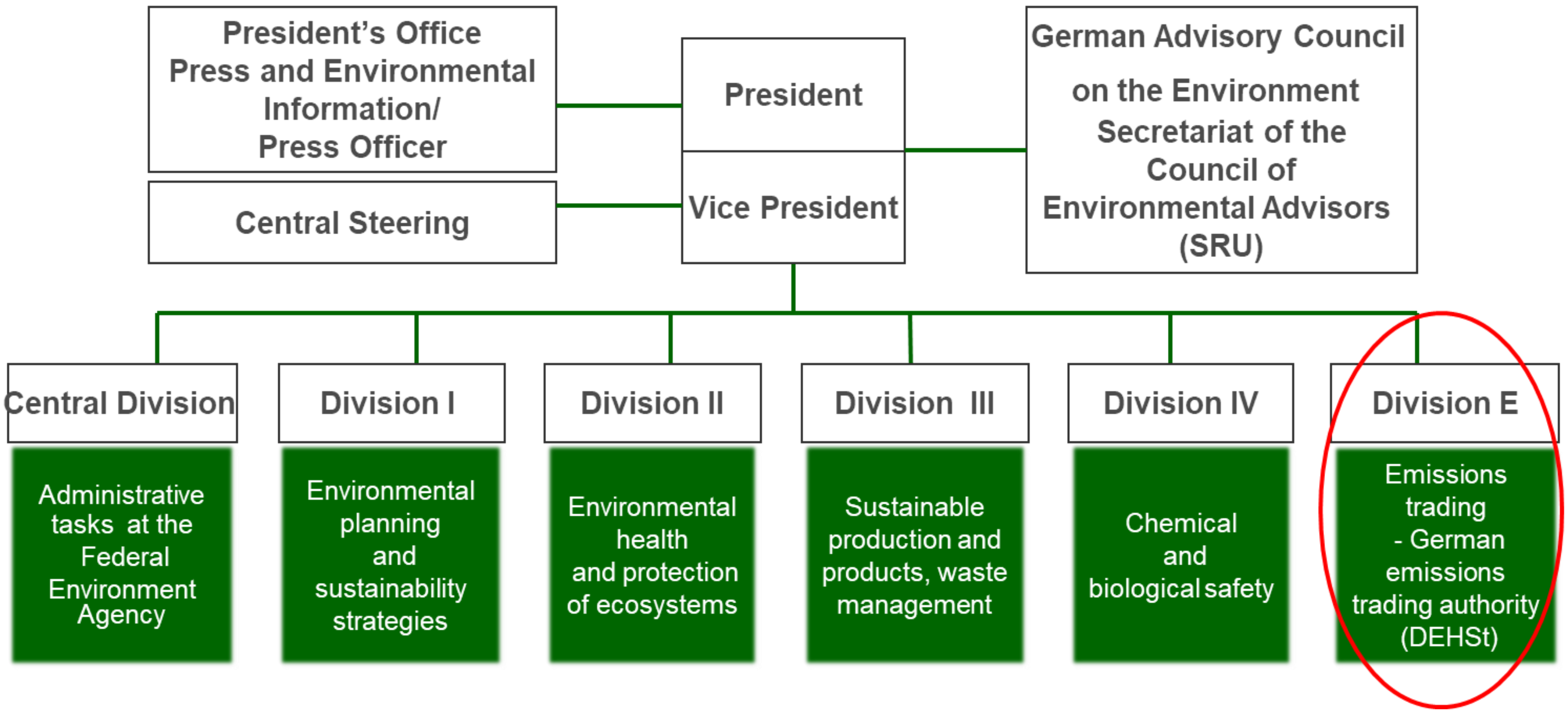
EU ETS
Institutional Framework

Organisational Structure of the Federal Environment Agency



EU ETS
Achievements

- **ETS infrastructure works well, robust database** available, **high compliance level**
- **EU-wide harmonization from Phase I to Phase III** (e.g. EU-wide cap, allocation rules, MRVA, Union registry…)
- **Learned from mistakes** (overallocation, windfall profits, criminal actions…)
- **Emissions reductions have been achieved**
  - EU: – 26 % in 2017 compared to 2005 in ETS sector
- **Behavioral changes within companies** – higher awareness of carbon costs and inclusion in investment decisions
- **Companies accept ETS** as an required carbon policy instrument
- **Market of emission allowances has matured and** performs comparably to other markets of related commodities

EU ETS
Challenges: Oversupply

- **Accumulated surplus of approx. 1,7 billion allowances in 2016 and decline in CO_2 allowance prices**
  (2008: 25 - 30 €; 2016: < 5 €)
- **Surplus caused by …**
  - **Financial and economic crisis** – resulted in reduction of output and emissions, which has not been anticipated
  - Considerable proportion of **credits from project-based mechanisms**
- **Scarcity** needs **to be restored** to give incentives **for long-term investments**
- **EU ETS could not contribute to the 2050 long-term goal of 80 – 95 % emission reduction**

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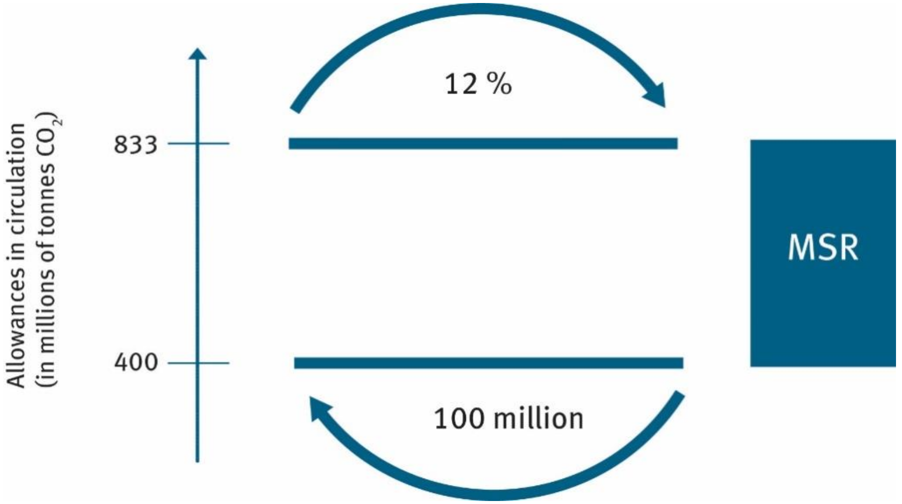
EU ETS
Structural Reform Phase III

- **Establishing a "Market Stability Reserve" (MSR)**
- **Start Date:**
  - First publication of "Allowances in Circulation" in 2017: 1.7 billion t CO_2
  - **First transfer of allowances into the MSR in 2019**
- **Backloading 2014 - 2016:**
  - 900 million t CO_2 to be directly transferred to MSR
- **Unallocated Allowances:**
  - To be directly transferred to MSR at the end of 3rd trading period

Allowances Issued
minus Verified Emissions
= **Allowances in Circulation**
(Surplus)



EU ETS
Structural reform through quantity control

Market Stability Reserve (MSR)

- **Basic considerations** to implement the MSR
  - **Protection** of the ETS **against external shocks** required
  - **Quantity based** mechanism like MSR **vs. price based** approach (e.g. floor price)
- The **MSR has the following effects:**
  - reduces surplus **stepwise**
  - is **rule based and transparent** for market participants
  - is quantity driven and **leaves price discovery to market**
  - **improves** the **stability** of the **ETS** and the price signal
  - **helps to avoid the "waterbed effect"** due to overachieving companion policy instruments (e.g. promotion of renewable energies)
  - prevents extreme burden in times of scarcity (**cost containment**)

EU ETS
Reform Phase IV

9 November 2017: EU legislative bodies agreed on **EU ETS reform** for **Phase IV to strengthen the ETS again:**

- **Cap reduction by 2.2 % p.a**. instead of 1.74 %
- **Doubling MSR intake rate** from 12 % to **24 % between 2019 and 2023** to restore scarcity in the early years of Phase IV
- **2023: Cancellation of allowances** in the MSR exceeding the total amount of allowances auctioned in the previous year (approx. 2 billion EUAs will be invalidated)
- **Avoiding „Waterbed Effect“: Member States** phasing out coal **may cancel allowances** for installations that ceased operation

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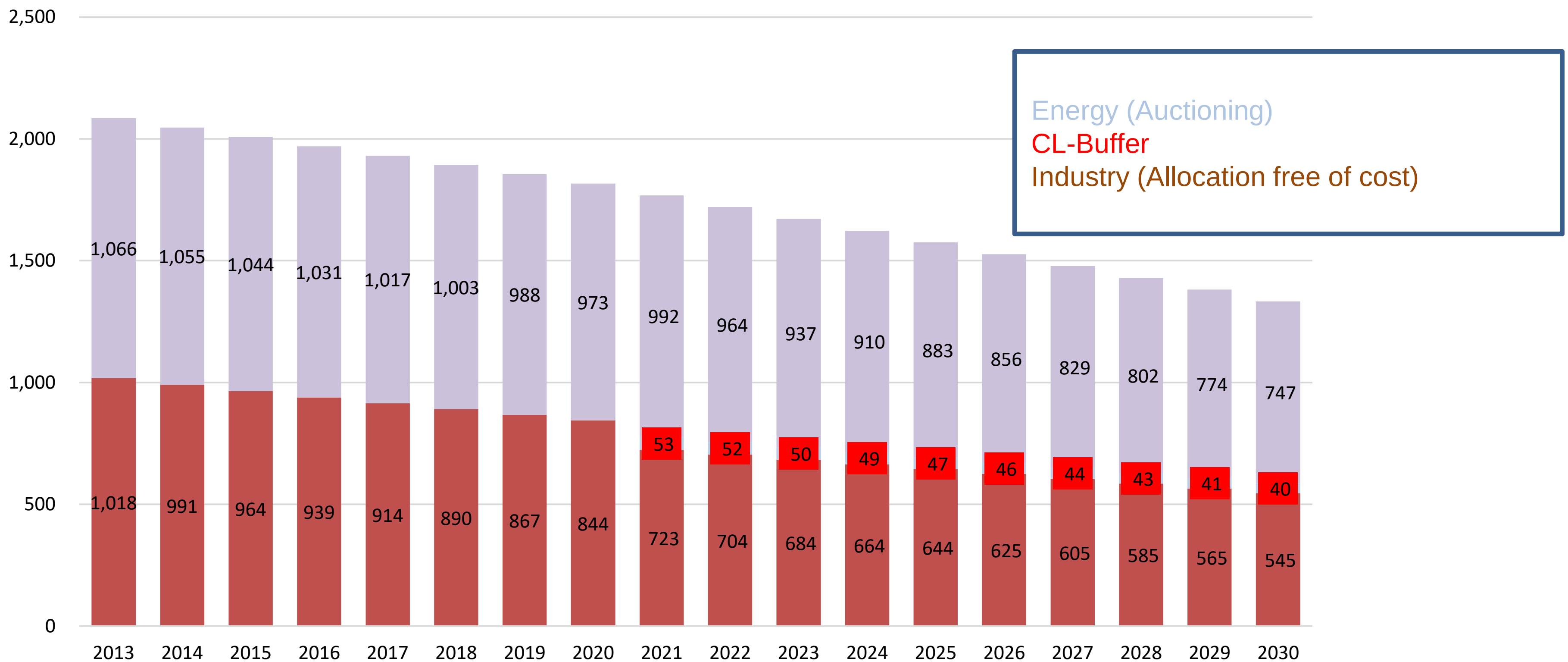
EU ETS
Cap in Phase III & Phase IV



Phase III 2013 - 2020: reduction factor 1.74 % annually (38 Mill t CO_{2e})
Phase IV 2021 - 2030: reduction factor 2.2 % annually (48 Mill t CO_{2e})

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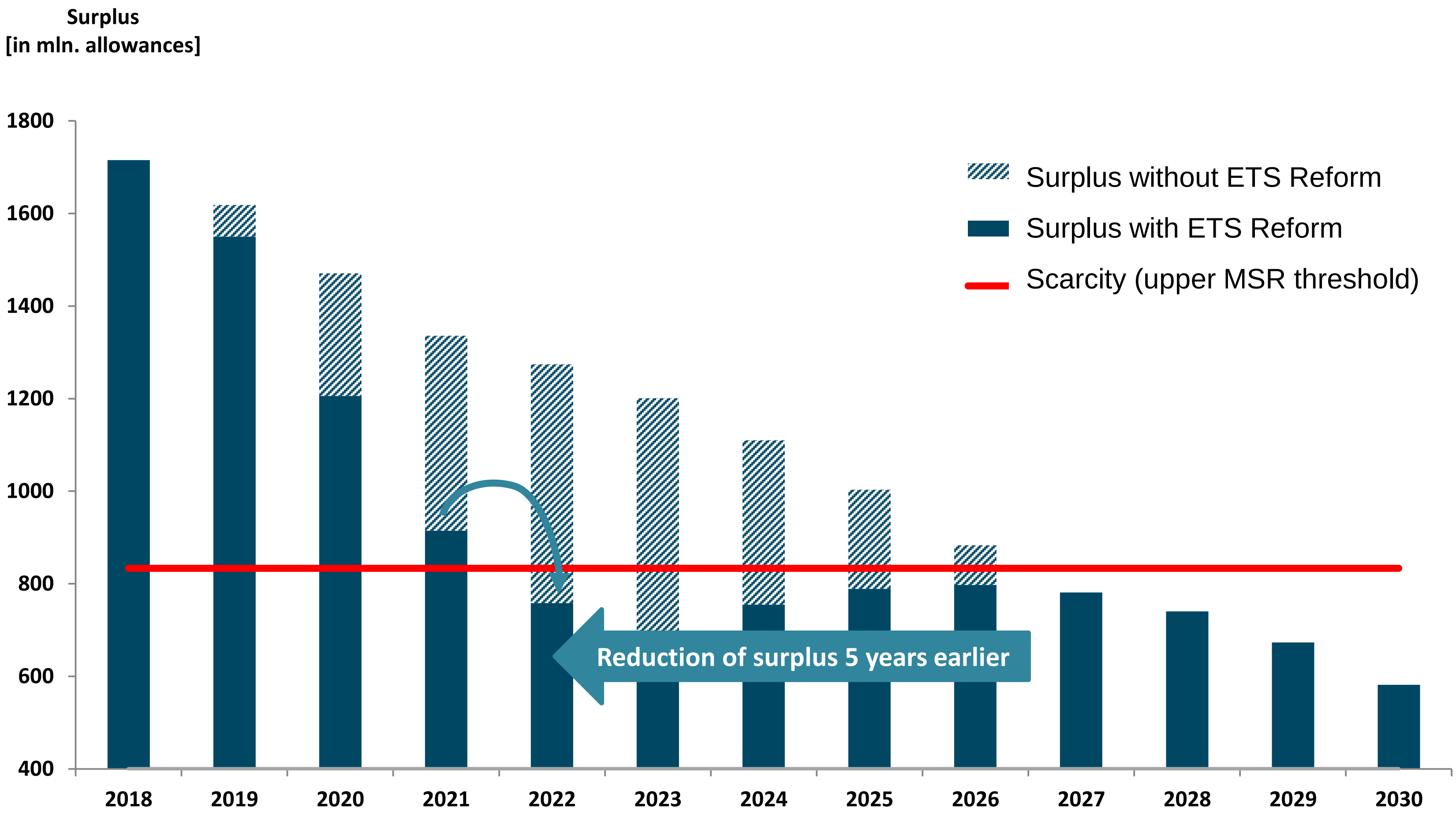
EU ETS
Strengthening in Phase IV



EU ETS

Further Reform Elements Phase IV

Addressing competitiveness concerns:

- **43 % of the Cap** to be **allocated free of costs (benchmarking** based on 10 % of the most efficient installations, updated annually between 0,2 and 1,6 %)
- **Comprehensive Carbon Leakage List**
- **100 % allocation** based on benchmarking for **Carbon Leakage Sectors** 2021 – 2030 (non-CL sectors 30 %, phasing out 2026 - 2030)
- **Avoidance** of **„Cross Sectoral Correction Factor“** (buffer)
- **„Dynamic Allocation“** regarding increases/decreases of the activity levels of installations

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EU ETS

Further Reform Elements Phase IV

Innovation & Solidarity Mechanisms:

- **Innovation Fund** (400 – 450 million EUAs)
  - Supporting the **demonstration of innovative technologies** (Renewable Energies, CCS, low-carbon technologies)
  - Eligibility: All Member States

- **Modernisation Fund** (310 – 385 million EUAs)
  - Modernisation of power sector and energy systems
  - Eligibility: Lower-income Member States

- **Up to 60 % of auctioning amounts** to be used for **allocation** free of cost for the **energy sector** in **low-income** Member States

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EU Emissions Trading System - on track again

EUA-price and surplus in the EU-ETS Phase II & III

Source: DEHSt, calculations based on data from Thomson Reuters Eikon, ICE, EU COM

EU ETS
What comes next?

- **Phase IV reform has already strengthened and will further strengthen the EU ETS and restore its price signal**
  (EUA price in October up to 25 €)

- **Performance of the MSR will be reviewed in Phase IV**

- **Further improvements?**
  - Cap reduction of **2.2 % p.a.** is still **not** in line with the 2050 long-term goal for a **net ghg neutral economy** (- 95 %)
  - **Improved monitoring and alignment** of EU ETS and **other climate policies**

Assessment of AER & Enforcement

Distribution of the Emissions covered in Germany

Installation category	Installations in Germany*	Total annual emissions*	
Category C (>500 kt CO_2-eq/a)	142	375.5 Mio. t CO_2-eq	82 %
Category B (>50 kt CO_2-eq/a)	412	61.8 Mio. t CO_2-eq	14%
Category A (<= 50 kt CO_2-eq/a) [installation with low emissions, < 25 kt]	1,326 [1,064]	18.1 Mio. t CO_2-eq [8.8 Mio. t CO_2-eq]	4% [1,9%]

*VET 2015; 1,880 installations, 455,4 Mio t