The Federal Ministry
for the Environment,
Nature Conservation
and Nuclear Safety

Session 5: Legal Treatment of Allowances
EU ETS/Germany

2nd Seminar on "Sharing Experiences on Legal Development and Implementation of ETS"
Bangkok, 11 June 2019

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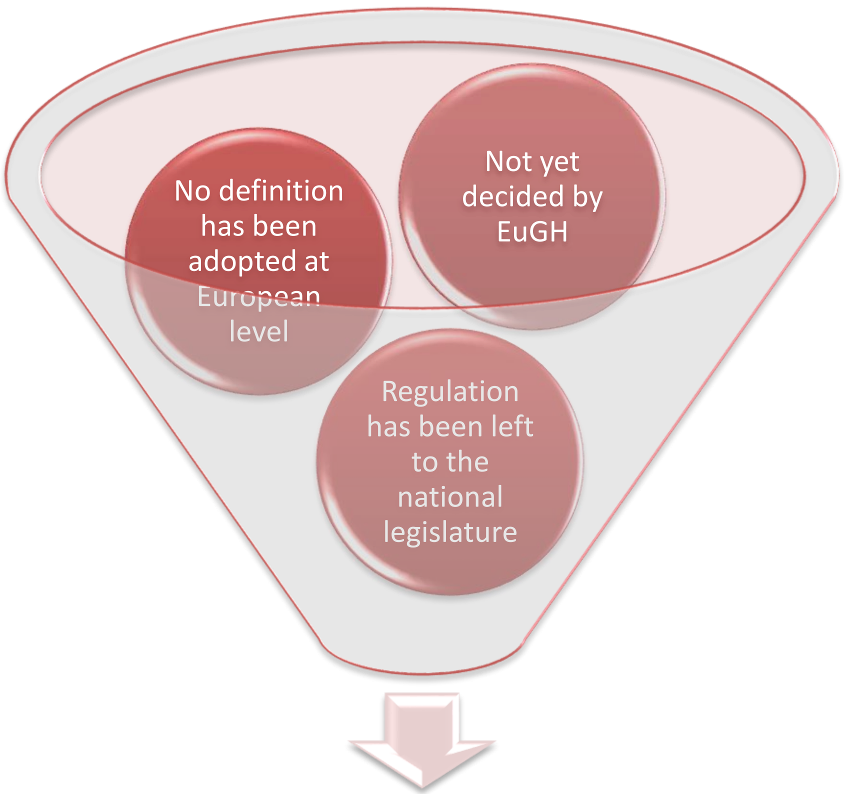
Outline

I. **Legal nature/treatment of allowances**

II. **Balance sheet treatment**

III. **Treatment in the law on collateral security**

I. Legal nature of allowances



Legal nature controversial

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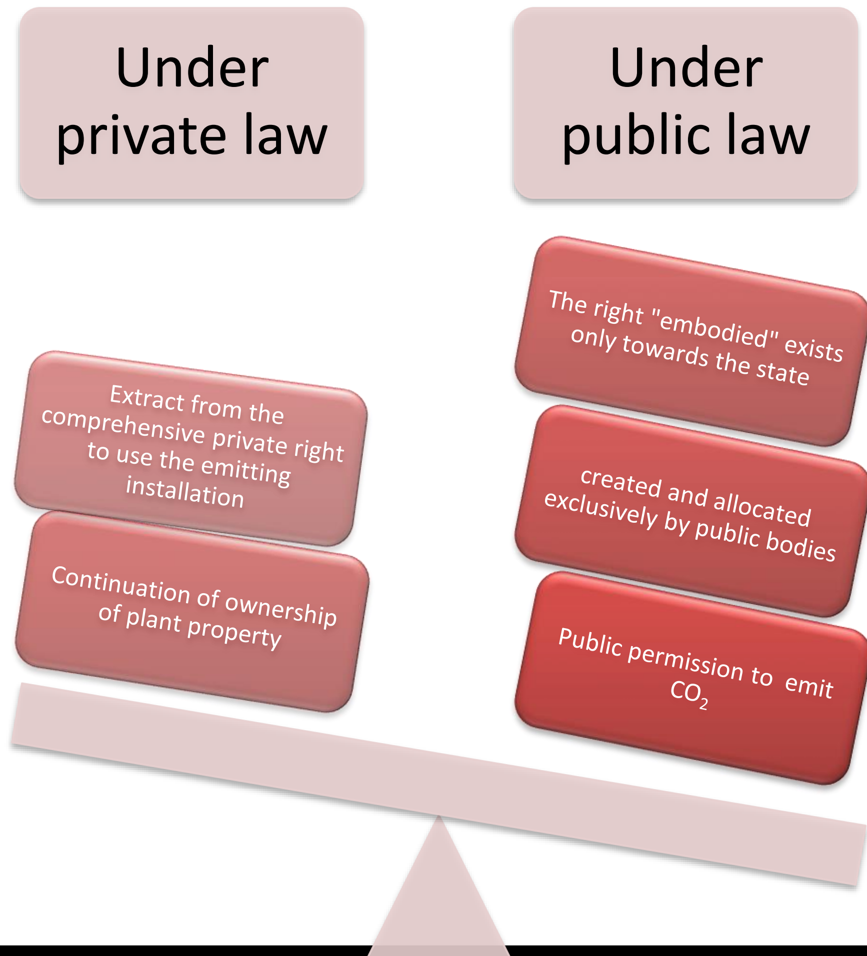
I. Legal nature of allowances



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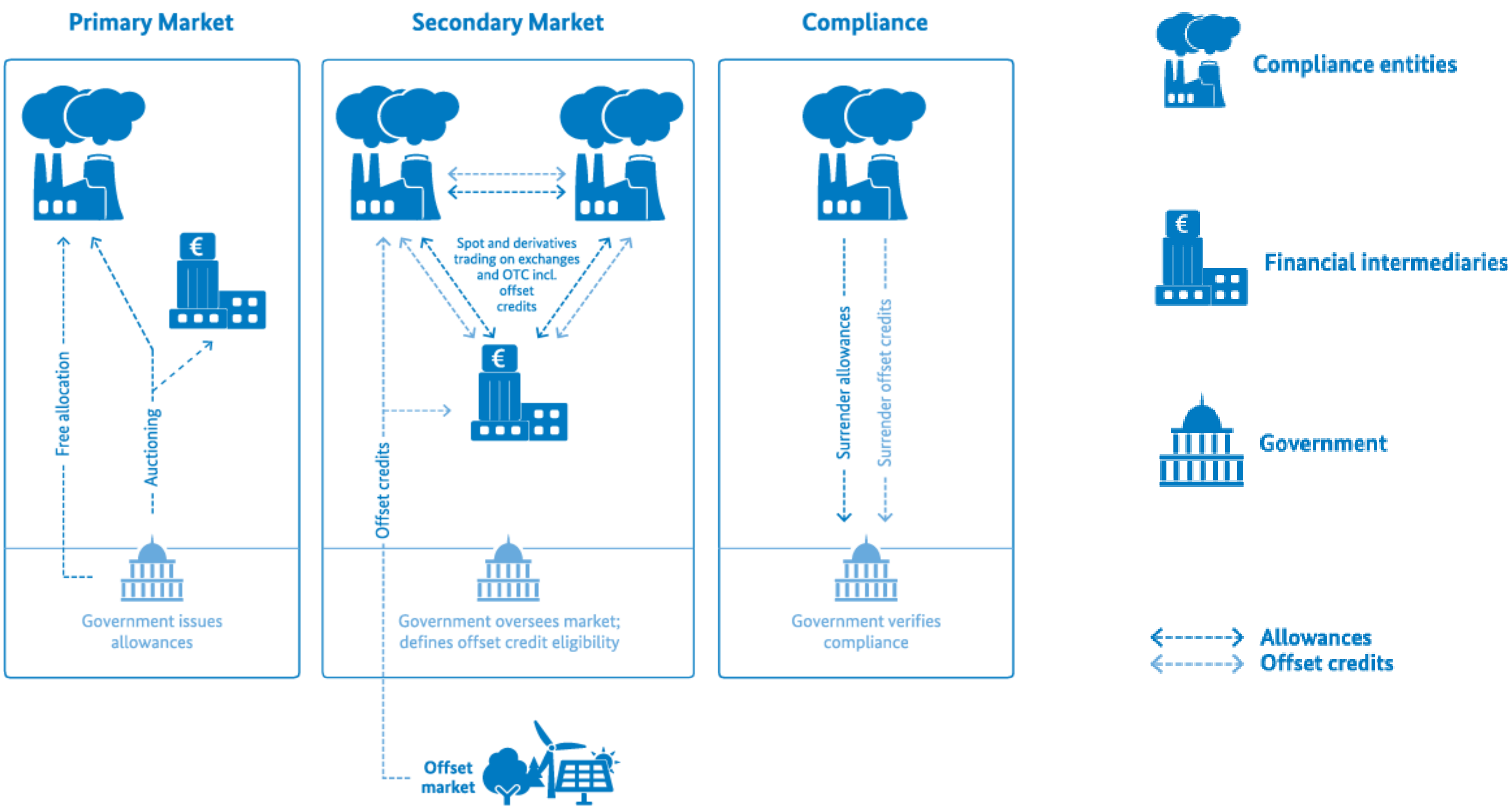
I. Legal nature of allowances
Trading/Flow of allowances



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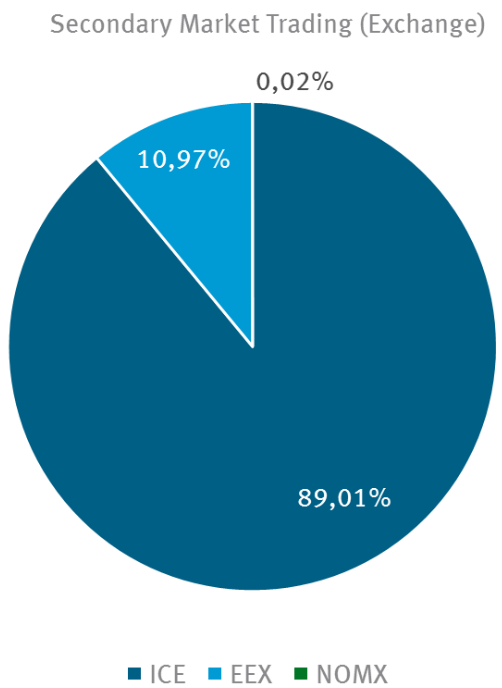
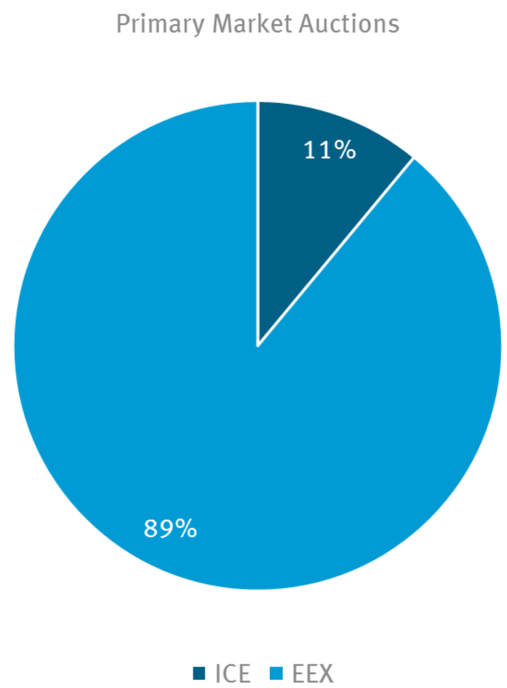
I. Legal nature of allowances
Market Shares 2018





I. Legal nature of allowances
Treatment for oversight purposes

- EU ETS emissions trading oversight is embedded into the already **existing financial markets infrastructure** (legislation and structures)
- The lion's share of transactions is in the form of **derivatives** (futures, forwards, options), which are subject to **EU financial markets regulation** (including MiFID II / MiFIR, MAR)
- **Spots** are subject to equivalent rules at the EU level as of 2018
- **Series of fraudulent activities** was experienced by the market a few years ago → however, these could not be directly attributed to the EU emission allowances market (e.g. phishing, tax fraud)
- Overall aim of the latest reform is the **enhancement of the market's overall transparency** both in terms of data publicly available to all participants and the information submitted to supervisors

I. Legal nature of allowances
Treatment for oversight purposes

- **MiFID II** regulates the **provisions of investment services** and **trading venues** in the EU.
- National transposition takes place in the German Exchange Act (BörsG) and the German Securities Trading Act (WpHG).
- **Markets in Financial Instruments Regulation** (EU) No 648/2012 (MiFIR) sets directly applicable rules for: trading venue transparency, trade reporting and transaction reporting.
- MiFID II and MiFIR are **complemented by several delegated acts**, regulatory standards and guidelines/FAQs.
- **Main purpose** is to ensure that trading in financial instruments is carried out as far as possible on **organised venues**.

II. Balance sheet treatment

- **Issued free of charge**
  - Valued at 1 € at the time of issue (reminder)
  - Valuation at “fair cost”
- **Purchased**
  - Valuation at acquisition cost

III. Law on Collateral Security

Pledge not possible

- No entry of the lien in the registry possible

Security transfer possible

- Full legal right to secure a loan is transferred to the creditor by agreement and registration.

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Thank you for your attention

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Session 6: Litigation on ETS

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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

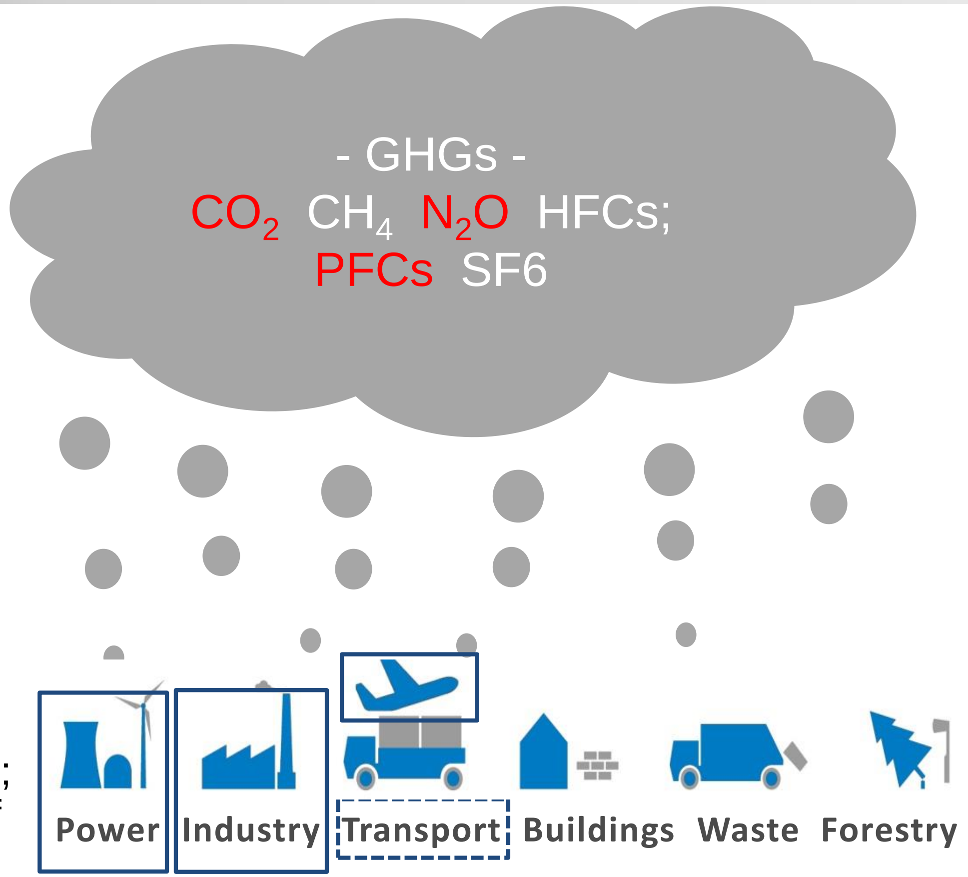
Downstream

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.

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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**

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**

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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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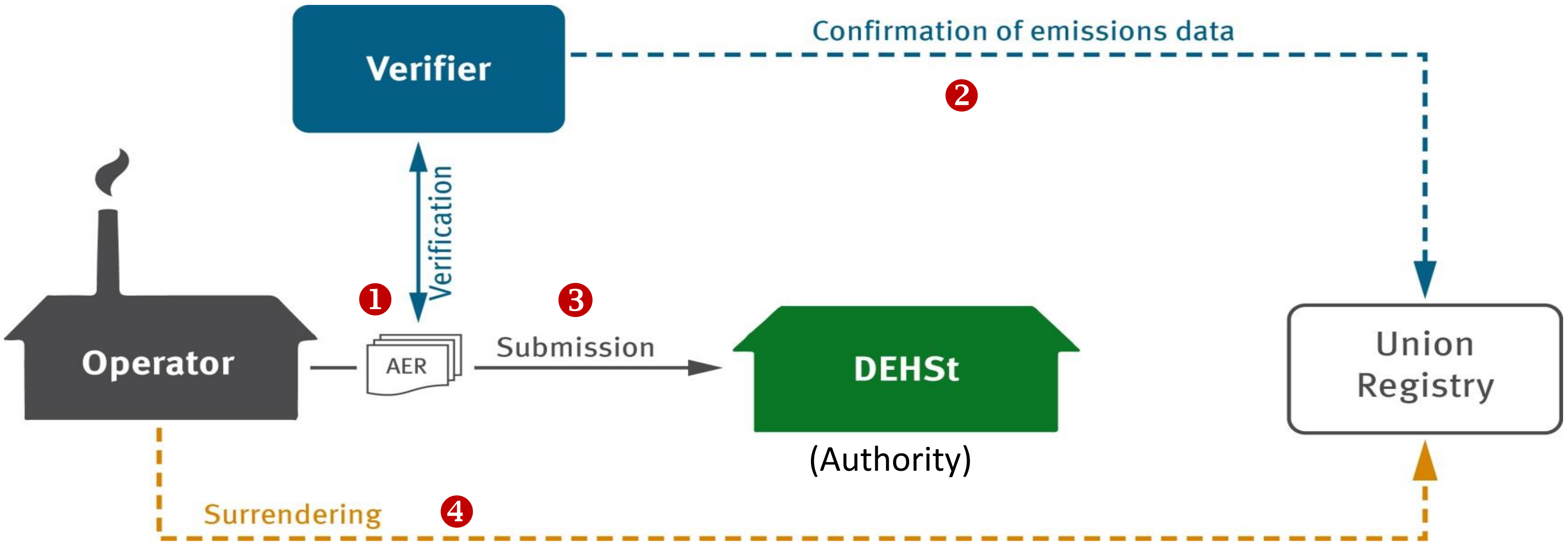
Excess Emissions Penalty I
Facts I



- **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**

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

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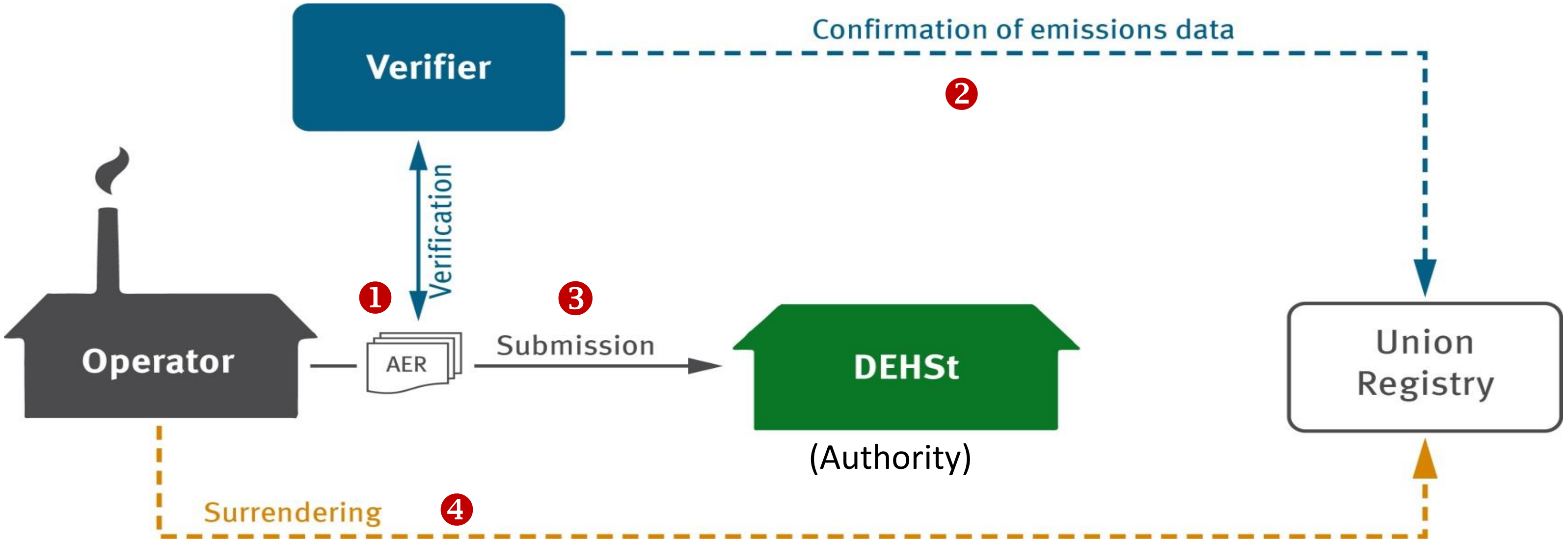
Excess Emissions Penalty II
Facts I



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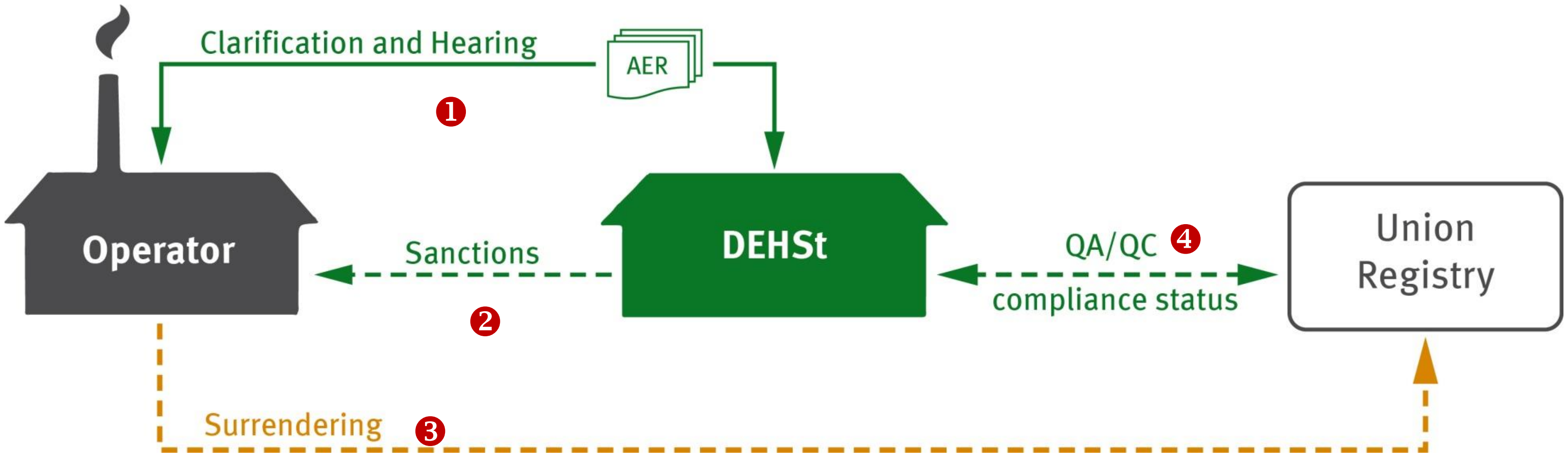
Excess Emissions Penalty II
Facts II



- **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**

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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**

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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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