Eszter Lilla SERES *

The question of compliance with the polluter-pays principle and State aid rules within the European Emission Trading Scheme **

Introduction

In the last decades, the topic on climate change has become a top issue that is considered on both international and European level. Thus aligning with the parallel international development tendencies had the European Union taken up the impetus in the advancement of this specific area.

With the gradual expansion of the European Community policies the question of environmental concerns being considered under competition law as well with specific regard to State aid rules. This question became quite relevant with the EU accessing the Kyoto Protocol, undertaking the obligation to reduce greenhouse gas emission by the commitment period of 2008-2012. The accession has led to the adoption of Community measures establishing a common European approach towards greenhouse gas emission, yet leaving enough space for the questioning of compatibility of EU legislation with the polluter-pays principle.

This essay aims at pointing out the core issues of the European Emission Trading Scheme with regard to the polluter-pays principle. The issue can be addressed through the analysis of the concept of State aid and their environmental implications. The main aim is to come to be able to come to a conclusion whether it is possible to strike a balance between environmental considerations and competition rules or whether there would be always a shift between the two approaches, precluding the possibility to address these issues together.

1. The importance of the polluter-pays principle

The polluter-pays principle has a history rooting back to its formation as an economic, rather than an environmental principle under the aegis of Organisation for Economic Co-operation and Development (OECD) in 1972, according to which *"the polluter should bear the expenses of carrying out the measures decided by public authorities to ensure that the environment is in an acceptable state. In other words, the cost of these measures should be reflected in the cost of goods and services which cause pollution in production and or consumption. Such measures should not be accompanied by subsidies that would create significant distortions in international trade and investment."*[1]

* dr. jur., legal officer, Department of Competition Law, Consumer Protection and Intellectual Property Rights, Ministry of Justice, e-mail: eszter.seres.92@gmail.com

** The opinions expressed in this article are the author's own and do not reflect the view of the Ministry of Justice; responsibility for the information and views expressed herein lies entirely with the author.

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The principle refers to the scarcity of environmental resources that nature has to be taken into account in the cost of production, so it can be correctly reflected in the market.[2] These failures can only be corrected by public measures capable of properly reflecting environmental deterioration in the prices of goods and services, enabling the allocation of costs of pollution prevention and control measures introduced by governments for polluting undertakings encouraging the `rational use of environmental resources´ and helps to `avoid distortions in international trade and investment.´[3]

These State measures can have differentiated importance, especially in relation to environmental protection: they can be used to eliminate an external cost or can be provided by the State for other environmental reasons.[4] Under the category of capturing an external impact, such subsidy `internalizes an externality.´[5] In this sense, these externalities have negative nature that had been identified by economists as market failures generally leading to public good or bad.[6] For instance, pollution by a firm in the course of production is considered a negative externality.[7] This serves as a clear indication of the fact that firms during the course of production, in which the input process utilises the environmental resources.[8] Due to the fact that certain amount of environmental degradation caused by a firm does not entail any cost for it, only has negative effect at societal level, the degradation – from the side of the market – does not necessarily become apparent at the time of the pollution.[9]

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[1] OECD: *Recommendation of the Council on Guiding Principles concerning International Economic Aspects of Environmental Policies,* C (72)128, 1972, point 4., in: http://acts.oecd.org/Instruments/ShowInstrumentView.aspx?InstrumentID=4&InstrumentPID=255&Lang=en&Book= (11.10.2016)

[2] OECD 1972, para. 2.; See further: Csák Csilla: Thoughts about the problems of the enforcement of the polluter pays principle, *European Integration Studies*, 2011/1, 27-40.

[3] Philippe Sands: *Principles of International Environmental Law*, Cambridge, Cambridge University Press, 2003, 281., https://doi.org/10.1017/CBO9780511813511; Bándi Gyula: A szennyező fizet elv és a környezetre veszélyes tevékenységgel okozott károkra vonatkozó felelősségi szabályok európai trendjei, in: Margitán Éva et al (edit.): *Nyugat-európai hatások a magyar jogrendszer fejlődésében*, Budapest, ELTE-ÁJK, 1994, 136-162.

[4] Hyun-Jing Kim: Subsidy, Polluter Pays Principle and Financial Assistance; *Journal of World Trade Law*, 2000/34., 119.; Nagy Zoltán: *Környezeti adózás szabályozása a környezetpolitika rendszerében*, Miskolc, Miskolci Egyetem, 2013, 44-77.

[5] Hyun-Jing Kim 2000, 120-121.

[6] Hans Vedder: *Competition Law and Environmental Protection in Europe; Towards Sustainability*?, Groningen Europa Law Publishing, 2003, 15.; Nagy Zoltán: The Instruments of the Environmental Policy's Economic Regulation with a Particular Regard to the Hungarian System, *Lex Et Scientia*, 2014/1, 77-88.

[7] Moritz Lorenz: *An Introduction to EU Competition Law,* Cambridge, Cambridge University Press, 2013, 23-24., https://doi.org/10.1017/CBO9781139087452; Bándi Gyula: *Környezetjog,* Budapest, Szent István Társulat, 2011, 56-58.

[8] OECD: *Economic Instruments for the Environmental Protection, Working Paper No. 92*, 1989, In: http://www.oecd.org/dev/1919252.pdf (20.10.2016) 5.

[9] Vedder 2003, 15.; See further: Bobvos Pál – Csák Csilla – Horváth Szilvia – Olajos István – Prugberger Tamás: A szennyező fizet elv megjelenése a mezőgazdaságban, *Journal of Agricultural and Environmental Law*, 2006/1, 29-55.

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At EU-level, the polluter-pays principle itself has been defined under Article 191 (2) of the Treaty on the Functioning of the European Union (TFEU), as the environmental policy of the Union is, inter alia, based on the polluter-pays principle.

2. The applicable rules concerning State aid measures

2.1. Qualification of the measure as State aid

The general aim of providing State aid in the field of environmental protection is to ensure that by the application of such measures the level of environmental protection will be higher than it would occur without the aid.[10] Without such subsidies, the market would fail to efficiently allocate resources, enabling the occurrence of negative externalities.

In general, unless otherwise provided, Article 107 (1) TFEU lays down the rule for the prohibition of granting State aid.[11] A State measure involving financial gains for certain undertakings that fulfils certain criteria will be considered as a State aid. These criteria are the following ones: the transfer of state resources, the advantage provided for an undertaking, selectivity, the distortion to competition and effect on trade between Member States.[12] As the case-law of the European Court of Justice does not provide an exact definition on State aid, rather describe measures and decisions of *"Member States in pursuit of their own economic and social objectives, give, by unilateral and autonomous decisions, undertakings or other persons resources or procure for them advantages intended to encourage the attainment of the economic or social objectives sought."*[13]

Firstly, the measure shall constitute a transfer of state resources, meaning that *"only advantages granted directly or indirectly through State resources are to be considered an aid."*[14] The distinction made in that provision between aid granted by a Member State and aid granted through State resources does not signify that all advantages granted by a State, – whether financed through State resources or not – constitute a State aid but is intended merely to bring within that definition any advantages which are granted

[10] Conor Quingly: *European State Aid Law and Policy*, Oxford, Hart Publishing, 2009, 271.; Olajos István: *A vidékfejlesztési jog kialakulása és története*, Miskolc, Novotni Kiadó, 125-126.; Guidelines on State aid for environmental protection and energy 2014-2020, OJ C 200, 2014, para. 30., in: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52014XC0628(01) (19.10.2016)

[11] Article 107(1) TFEU: *„Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."*

[12] Legih Hancher – Tom Ottervanger – Piet Jan Slot: *EC State Aids*, London, Sweet & Mawell, 2006, 500.

[13] Case C-61/79 Amministrazione delle Finanze Stato v Devankit Italiana [1980] ECR 1980-01205, para. 31.

[14] Case C-379/98 PreussenElektra AG v Schhleswag AG [2001] ECR I-02099, para. 58.

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"directly by the State and those granted by a public or private body designated or established by the State."[15]

Additionally, the notion of State aid can encompass not only positive benefits, such as subsidies, loans or direct investment in the capital of enterprises, but also interventions that mitigate the charges which are normally included in the budget of an undertaking.[16] Secondly, the aid has to be imputable to the State.[17] In this manner, when the measure and granting is determined by a body that is subjected to the control and the instructions of the public authorities, it is attributable to the Member State concerned by possibly forgoing the profit which it normally could realize.[18] Thirdly, the grant of funds must be subject to approval by the public authorities.[19]

For the second requirement, that the advantage must be provided for an undertaking, Article 107 (1) TFEU covers both private and public undertakings.[20] Under EU competition law, any person or organisation pursuing an economic activity is considered an undertaking.[21] Thus regardless of the legal status of the entity and the way in which it is financed,[22] the main emphasis is put onto the examination of whether the undertaking offers goods or services on a market,[23] without the necessity of generating profit.[24]

The third criterion for a measure to qualify as a State aid is selectivity. Speaking in general terms, Member States cannot be compelled to refrain from the introduction of measures belonging to the area of general economic policy,[25] meaning that the criterion of selectivity will be only met if under a *"particular statutory scheme a State measure favours certain undertakings or the production of certain goods over others which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question."*[26]

[15] Case C-379/98 PreussenElektra, para. 58.
[16] Case C-126/01 Ministère de l'Économie, des Finances et de l'Industrie v GEMO SA. [2003] ECR I-13769, para. 28.
[17] Case C-482/99 France v Commission (Stardust Marine) [2002] ECR I-04397, para. 68.
[18] Case C-67/85 Kwekerij Gebroeders Van der Kooy BV and Others v Commission of the European Communities, [1988] Reports of Cases 1988 00219 para. 220.
[19] Vedder 2003, 285.
[20] Case C-78/76, Steinike & Weinlig v Federal Republic of Germany [1977] Reports of Cases 1977 00595 para. 18.
[21] Várnay Ernő – Papp Mónika: Az Európai Unió joga, Budapest, Complex Kiadó, 2013, 713.
[22] Case C-41/90 Klaus Höfner and Fritz Elser v Macrotron GmbH. [1991] Reports of Cases 1991 I-01979 para. 21.
[23] Várnay – Papp 2013, 713-714.
[24] European Commission: Commission notice on the notion of State aid as referred to in Article 107 (1) of the Treaty on the Functioning of the European Union, C 262/01, 2016, para. 9., in http://eur-lex.europa.eu/legal content/EN/TXT/PDF/?uri=CELEX:52016XC0719(05)&from=EN (22.10.2016)
[25] Várnay – Papp 2013, 1004.
[26] Case C-409/00 Kingdom of Spain v Commission of the European Communities. [2003] ECR I-01487 para. 47.

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When the body granting financial assistance enjoys a degree of latitude, enabling it to choose the beneficiaries or the conditions under which the financial assistance is provided, that assistance cannot be considered to be a general economic measure in nature,[27] leading to the conclusion that discretion on the part of the aid granting authorities can be seen as an indicator of selectivity.[28]

Finally, the fourth criterion is the effect on trade between the Member States, namely that the State aid must be capable of distorting competition and affecting trade between Member States.

2.2. Compatibility of State aid with the Internal Market

An environmental measure qualified as State aid may still be legal if it is held to be compatible with the Internal Market under Article 107 (3)(c) TFEU. Under Article 107 (3) TFEU the Commission has discretionary power to consider an aid compatible with the internal market rules. This discretionary power of the Commission is now delimited by the Commission Regulation on General Block Exemption Regulation (GBER),[29] under which State aid measures aiming at the protection of the environment has gained emphasis with the parallel underlining of the polluter-pays principle.

As environmental protection is one of the main horizontal objectives in State aid regulation,[30] the Commission has issued the Guidelines on State aid for environmental protection that is now available for the period of 2014-2020 (the Guidelines). In general, the aim of the Guidelines is to protect the environment in such manner to support any action is designed to remedy or to prevent damage to the environment or natural resources and to the encouragement of the uses of these resources.[31] It provides a degree of transparency for Member States and for undertakings to be able to foretell the criteria they will have to meet and that the Commission will apply in the course of assessment on compatibility with the internal market rules.[32] Yet it does not generally assume the compatibility of every aid that is covered by it, only providing a presumption for compatibility in cases of meeting certain criteria set out in it.

The Guidelines emphasize the need for positive or incentive effect of an environmental aid to be considered compatible. This incentive effect means that the aid has to induce the beneficiary to change its behaviour to increase the level of environmental protection that would have not been undertaken without the aid.[33]

[27] Case C-256/97 Déménagements-Manutentuin Transport SA [1999] ECR I-03913 para. 27.
[28] Vedder 2003, 293.
[29] Commission Regulation No. 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty
[30] Várnay – Papp 2013, 1014.
[31] Hancher – Ottervanger – Slot 2006, 508.
[32] Volker Zuleger: Compatibility of State Aid pursuant to Article 87 (3) EC, In: Martin Heidenhain (edit.): *European State Aid Law*; Munich, Beck, Hart and Namos Publishing, 2010, 270.
[33] 2014 Guidelines, para. 49.

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This effect is required to be present in all aid measures, leading to an extra level of protection in relation to the given situation.[34] An aid cannot be considered necessary solely because the level of environmental protection is increased.[35] Measures under which the negative effects manifestly outweigh the positive effect of the aid cannot be deemed compatible with the internal market.[36] On the basis of the negative and positive effects, the Commission will balance the effects and determine whether the resulting distortions adversely affect trading conditions to an extent contrary to the common interest.[37] If the expected negative effects outweigh the positive effects, the environmental aid cannot be executed whereas in the case of positive effects prevailing, the Member States will be permitted to provide the aid for the undertakings.

3. The European Emission Trading Scheme (ETS)

From the point of view of international environmental law, with the 1997 adoption of the Kyoto Protocol to the UN Framework Convention on Climate Change, the quantitative restrictions on emissions from industrialised economies has been established.[38] The Protocol provides a global market[39] for trading in emission permits between industrialised countries.

In Article 17 the Kyoto Protocol sets out the basics of emission trading. Article 3 of the Protocol aims the reduction of overall emissions by the contracting parties of greenhouse gases by at least 5% below their 1990 levels for the commitment period 2008 to 2012. If the Parties have not met their commitments set out in Annex B, then they are able to trade units in the form of assigned amount units, certified emission reductions, emission reduction units and removal units.[40]

In 2001 the Commission has issued a Green Paper on greenhouse gas emissions trading within the European Union,[41] which has established a conceptual framework and basic ideas for the European Emission Trading Scheme.

[34] Phedon Nicolaides – Maria Kleis: A Critical Analysis of Environmental Tax Reduction and Generation Adequacy Provisions in the EEAG 2014-2020, *European State Aid Law Quarterly*, 2014/14, 639-640.
[35] Quingley 2009, 291.
[36] 2014 Guidelines, para. 94.
[37] Quingley 2009, 293.
[38] Patricia Birnie – Alan Boyle – Catherine Redgwell: *International Law and the* Environment, Oxford, Oxford University Press, 2009, 360-361.
[39] OECD: *Emission Permits and Competition,* DAF/COMP(2010)35, 2011, in: http://www.oecd.org/competition/sectors/48204882.pdf, (10.11.2016) 32.; See further: Fodor László: A kibocsátási egységek kereskedelme: Európajogi alapok – a német és a magyar nemzeti szabályozás 2004-2012 között, *Journal of Agricultural and Environmental Law*, 2013/14, 3-52.
[40] Birnie – Boyle – Redgwell 2009, 367.
[41] European Commission: *Green Paper on greenhouse gas emissions trading within the European Union*, COM/2000/0087, in: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A52000DC0087 (10.11.2016) point 7.1.

Even by that time, the Commission had already taken the view that some of the measures adopted by Member States in order to comply with the Kyoto Protocol could constitute a State aid, yet it took the view it was *"too early to lay down the conditions for authorising any such aid."*[42]

In the Paper, the Commission outlined how crucial was the establishment of a scheme that could place equitable burden on every sector or actor within the ETS compared to actors outside of it. The Commission has emphasised two different market-based instruments through what the scheme should be approached: auctioning or grandfathering of allowances, in other words, allocation free of charge.[43] Auctioning is basically in line with the polluter-pays principle, as the revenues from the auctioning can be utilised in many possible ways in order to decrease environmental harm and enhance the level of protection. On the other hand, a different approach called benchmarking was considered, as grandfathering could only provide a solution on the basis of a historical emission data that would lead to rewarding the largest emitters and not for companies who already undertook measures for the reduction of environmental harm. Benchmarking provides a basis to set up performance standards in relation to a specific installation that during the course of production harms the environment.[44]

Finally, the insights provided by the Green Paper have led to the adoption of the 2003/97/EC Directive establishing the European Emission Trading Scheme (ETS).[45] The main aim of the establishment of the ETS is to *"promote reductions of greenhouse gas emissions in a cost-effective and economically efficient manner."*[46]

[42] European Commission: *European Emission Trading Scheme Handbook*, 71.

[43] In the Green Paper, grandfathering had been defined as strictly not being *„related to the notion of the allocation free of charge of a realisable asset, but rather to a historical right to do something, such as vote, that can be transmitted to descendants or retained by a legal entity during its continued existence, but which is not transferable beyond those pre-determined limits."*; See further: Fodor László: A kibocsátási egység – új típusú vagyoni értékű jog a klímavédelem szolgálatában, *Collectio Iuridica Universitatis Debreceniensis*, 2008/7, 161-200.

[44] European Commission: *Green Paper 2000,* point 7.2.2.

[45] 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; Concerning the European Emission-Trading Scheme see further: Az uniós emisszió-kereskedelmi rendszerről lásd: Horváth Szilvia: *A kibocsátási jogok kereskedelmének nemzetközi háttere, közösségi szabályozásának alakulása*, PhD-értekezés, SZTE, 2007; and Horváth Szilvia: Az Európai Közösség éghajlatváltozás elleni politikájának kezdeteiről, *Journal of Agricultural and Environmental Law*, 2007/2, 20-40.

[46] EU ETS Directive, Article 1.

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This scheme has established a so-called cap-and-trade system, or absolute regime,[47] that provides an overall greenhouse gas emission capping for all participants of the regime, with a fixed upper limit.[48] The system provides a possibility for undertakings carrying out a polluting activity to buy emission allowances from other undertakings that can abate at lower costs.[49]

The first phase of the ETS took place from 2005-2007, while the second phase of 2008-2012,[50] each Member State could decide upon the total quantity of allowances it would allocate.[51] Under Phase 1 and 2, the emission permits were granted free to the emitters, as it was presumed that it would substantially reduce the costs for installations, while – questionably – keeping the economic incentives to reduce emissions.[52] In the first period, the scheme provided the possibility for Member States to auction their allowances up to 5%, while in Phase 2, this limit had been increased to 10% while allowances had to be supported by an Assigned Amount Unit as there was an inherent State aid potential by the free or below market price allocation of allowances under the EU ETS.[53]

One of the striking specialties of the Directive was that it only provided restriction on the upper limit of the national emission cap in Annex III that had be consistent with the commitments under the Kyoto Protocol. Secondly, under Article 10, in the first phase, 95% of the allowances, while for the second phase 90% had to be allocated free of charge – through grandfathering. Although in the Green Paper the Commission had argued that auctioning would be the more favourable approach, at the outcome, clearly the provision of a larger leeway for Member States had prevailed. Furthermore, the Directive itself does not provide any guidance in connection to State aid provisions, only states that, under Annex III, *"national allocation plans 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 Articles 87 and 88 of the Treaty."*

As the polluter-pays principle formed an integral part of the EU environmental policy, it is quite questionable that in Phase 1 and 2 the allocation free of charge could be considered as an approach consistent with environmental concerns. Strictly interpreted, through the granting of free allowances, the Member States undertook to renounce incomes that could be invested into the levelling of environmental protection.

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[47] Suzanne Kingston: *The role of Environmental Protection in EC Competition Law and Policy,* PhD thesis, 2009 in: https://openaccess.leidenuniv.nl/bitstream/handle/1887/13497/Suzanne+Kingston+PhD+Thesis.pdf?sequence=1 (11.11.2016) 50.; Nagy Zoltán: Az emisszió-kereskedelmi rendszerek szerepe a környezetpolitikában, in: Raisz Anikó (edit.): A *nemzetközi környezetjog aktuális kihívásai*, Miskolc, Miskolci Egyetem, 2012, 118-128.

[48] European Commission: *European Emission Trading Scheme Handbook*. 16.

[49] OECD: *Emission Trading Systems,* in: http://www.oecd.org/env/tools-evaluation/emissiontradingsystems.htm (10.11.2016)

[50] Fodor László: A kibocsátási egységek kereskedelmi rendszerének bevezetése Magyarországon, *Publicationes Universitatis Miskolciensis Series Juridica et Politica*, 2007/25/1, 289-316.

[51] ETS Directive Article 11.

[52] OECD 2011, 173.

[53] Kingston 2009, 255.

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Yet from the other point of view, it can be argued that only the subsequent 5% and 10% accorded within Phase 1 and 2 could be seen as the bypassing of the polluter-pays principle, as Member States were granted a small but existing latitude concerning these percentages. Furthermore, as Annex III of the Directive had only provided a general reference to the State aid rules under the Treaty, the question on what national measures could amount to State aid under the ETS was left open. Theoretically, the scheme was inconsistent with State aid rules as it provided tradable emission permits free of charge, while having recourse to auctioning, these tradable permits could have become part of the State revenues. Clearly, under ETS, the Member States forfeited these revenues and undertakings that had previously abated their level of emission could capitalise the amount of allowances in excess of their usage.

Considering the notion of State aid, Phase 1 and 2 of the EU ETS can be assessed in the following points. Firstly, as is has previously been established, the aid must be granted by a Member State or at least indirectly through State resources, by a public body or a private body established by the State. According to the analyzation of LORENZ, the representative opinion at the time of the establishment of the ETS were that the regime precludes the existence of an aid, *"as the benefits form the tradability of the allowances stems from the trade between private parties."*[54] The other group of literature counter argued that the potential revenues that were inherent in the emission allowances are tantamount to the requisite of granting through state resources. The second criteria is the conferring an economic advantage on undertakings. As the undertakings who were participants of the affected industrial sectors could benefit from the ETS cap-and-trade system without having to buy the allowances, the allocation had provided an advantage that could be fully utilised or later sold to other participants or new entrants. Thirdly, the question of selectivity has to be examined from the side of the sectors covered and the participants of the scheme. The system cannot be regarded as being selective on the basis that it covers only certain sectors, yet the Commission in some cases considered that the coverage of only certain industry sectors and companies amounts to selectivity.[55] The issue of selectivity can be found in the core of the ETS as well. As Member States had to allocate and auction the allowances at the beginning of the phases, the late entrants had to purchase the allowance they would need through the market.[56] The following issue is the distortion of competition that the Commission itself had recognised in emission trading schemes before the ETS Directive had entered into force.[57] Furthermore, the distortion of competition can appear in relation to an energy efficient undertaking that had undertaken actions to reduce its emission prior to participation in such scheme and national allocation plans does not take such considerations into account.[58]

[54] Moritz Lorenz: Emission Trading – State Aid Dimension, *European State Aid Law Quarterly*, 2004/3, 401.
[55] Lorenz 2004, 402.
[56] 2014-2020 Guidelines, para. 235.
[57] Commission Decision of 28.11.2001, Case N 416/2001 – United Kingdom, 9.
[58] Lorenz 2004, 402.

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4. The Dutch NO_x Emission Trading Scheme

The regime had been established previously to the adoption of the ETS Directive. The Dutch regime was created on the basis of the Directive 2001/81/EC on national emission ceilings for certain atmospheric pollutants. Under the Directive, the Dutch national emission ceiling was set at 260 kilotons by 2010.[59] The authorities considered that emission permit requirements and legislation on the emission limits were insufficient instrument in meeting the target for 2010.[60] So the introduction of a new scheme deemed to be crucial. The system to be established was mandatory and every undertaking must have complied with the scheme by abating NO_x in their facilities or by purchasing emission reduction allowances that were or would be achieved elsewhere, or by a combination of both.[61] Under the scheme parallel to the compulsory compliance, trading was optional, where the facilities could decide whether and to what extent do they wish to exchange emission reductions for the given year or for the future year. The scheme was called a dynamic cap system.[62] As the upper cap was not limited, but was dynamic with the possibility of gradual growth. The Dutch authorities have set an upper ceiling for selling may not exceed the maximum reductions that an undertaking can make given the emission standard.[63]

The Commission during the course of its procedure noted that with the authorities having an option to sell or auction emission permits, it has led to the establishment of a scheme in which the permits constitute State resources within the meaning of Article 87 (1) of the EC Treaty.[64] Furthermore, as the scheme was only favourable for the largest 250 undertakings, constituting a specific group that was active participation in trade between Member States, the scheme strengthens their position, leading to the change of market conditions for their competitors. Although the conditions for the measure to be caught under Article 87 (1) had been clearly established, the Commission had examined whether it can be saved under Article 87 (3)(c). As the trading scheme was an additional effort before the adoption of Community rules that rewarded undertaking which went beyond the existing standards, achieving environmental benefit, the Commission considered the measure compatible with the common market, saved under Article 87 (3)(c).

[59] Commission Decision C(2003) of 24 June 2003 on State Aid N 35/2003 – Ducth NO_x Emission Trading Scheme, 1.
[60] Hancher – Ottervanger – Slot: 2006, 544.
[61] Commission Decision N 35/2003 – Ducth NO_x Emission Trading Scheme, 2.
[62] Commission Decision N 35/2003 – Ducth NO_x Emission Trading Scheme, 5.
[63] Commission Decision N 35/2003 – Ducth NO_x Emission Trading Scheme, 7.
[64] Commission Decision N 35/2003 – Ducth NO_x Emission Trading Scheme, 9.

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The decision of the Commission was subjected to criticism as it did not take into account certain circumstances, such as that large industrial facilities were subjected to additional emission requirements compared to other facilities and that the value of the permits were as much dependent on the effort of the participating facilities as of the government's permission to trade them.[65] Moreover, the other argument criticising the Commission's approach is that there were no existing allowances until there's an undertaking acting under the scheme that would be producing so efficiently to create allowances.[66]

After the Commission's decision the case was tried before the Court of First Instance, coming to the conclusion that the NO_x trading scheme constituted an advantage granted to the undertakings concerned through State resources. This line of argument was based on the circumstances that the scheme authorised undertakings subject to those standards to trade the emission allowances between themselves up to the limit applicable to each of them, thus due to the tradability of the allowances, the scheme conferred market value onto them.[67] It is therefore the tradability of the allowances provided by the measure that constitutes an advantage for the enterprises.[68] Furthermore, the CFI had examined the question of selectivity as well, coming to the conclusion that the scheme was based on objective considerations and that the measure in question aimed at the undertakings being the largest polluters setting out an objective criterion in conformity with the goal of the measure, namely, the protection of the environment.[69] With regard to the objective pursued and the specific obligations imposed on large industrial facilities by the measure in question, the CFI held that the legal and factual situation of the undertakings subject to that NO_x emission ceiling cannot be regarded comparable with undertakings to which that ceiling does not apply.[70] The mere possibility to restrict the measure concerned to 250 undertakings was not enough to establish the existence of a selective measure.[71] Thus without the selectivity criterion being fulfilled, the measure could not be seen as State aid under Article 87 (1).

[65] Piet Jan Slot: NO_x Emission Trading Rights: A Government Gift or Value Created by Undertakings?; *European State Aid Law Quarterly*, 2013/12, 62.
[66] Slot 2013, 67.
[67] Case T-233/04, Kingdom of the Netherlands v Commission of the European Communities [2008] ECR II-00591 para. 70.
[68] Case T-233/04, Kingdom of the Netherlands v Commission of the European Communities [2008] ECR II-00591 para. 74.
[69] Case T-233/04, Kingdom of the Netherlands v Commission of the European Communities [2008] ECR II-00591 para. 88.
[70] Case T-233/04, Kingdom of the Netherlands v Commission of the European Communities [2008] ECR II-00591 para. 90.
[71] Case T-233/04, Kingdom of the Netherlands v Commission of the European Communities [2008] ECR II-00591 para. 95.

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After the CFI's judgement, the case on appeal was tried before the Court. Regarding selectivity, the Court had established that the concept of aid *"does not encompass measures creating different treatment of undertakings in relation to charges where that difference is attributable to the nature and general scheme of the system of charges in question"*[72] The ECJ had analysed whether the Netherlands could prove that the measure was capable to avoid the classification as being selective for the purposes of Article 87 (1) EC Treaty, it came to the conclusion that neither the nature, nor the general scheme of that legislation was capable to justify such differentiation.[73]

Concerning the question whether the characteristic of the Dutch scheme was of an advantage granted through State resources, the Court provided the following interpretation. As the tradability of emission allowances is dependent on the fact that the State authorises the sale of those allowances and that the State allows those undertakings emitting a surplus to acquire from other undertakings the missing emission allowances, this enables the creation of a market for the allowances.[74]

5. The revision of the ETS scheme

As for the third phase, the ETS went through significant developments. The 2009/29/EC Directive[75] even aims at the unfolding of a larger-scale of potential of the ETS – partially learning from the mistakes of the first two phases. The Directive has introduced a new target for the reduction of greenhouse gas emissions of 20% decrease compared to the level of the 1990 emissions, with a view to shift to full auctioning by 2027.[76] In order to achieve this aim, the quantity of allowances shall be decreased annually, equally to 1,74 % of the allowances.[77] The scheme had been extended to other forms of facilities, providing a larger scope of application to industrial activities.[78]

The New Directive had already addressed the issue of carbon leakage as well,[79] namely, the phenomenon under which the emission reduction initiatives in one country may lead to the increase of emissions in other countries, as undertakings from a country applying a more stringent approach in emission reductions might just outsource its producing activity to countries where the emission regulation is not that demanding, leading to a sector-specific leakage that can be in the range from 0 to 100%.[80]

[72] Case C-279/08 P European Commission v Kingdom of the Netherlands [2011] ECR I-07671 para.62.
[73] Case C-279/08 P European Commission v Kingdom of the Netherlands [2011] ECR I-07671 paras. 76-78.
[74] Case C-279/08 P European Commission v Kingdom of the Netherlands [2011] ECR I-07671 para. 88.
[75] Directive 2009/29/EC of the European Parliament and of the Council of 23 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community
[76] Directive 2009/29/EC, Preamble, point 5.
[77] Directive 2009/29/EC, Preamble, point 13.
[78] Directive 2009/29/EC, Preamble, point 10.
[79] Directive 2009/29/EC, Preamble, point 26.
[80] OECD 2011, p. 10.

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In this relation, the New Directive had considered the possibility for Member States to provide for the temporary compensation for installations that face *"a significant risk of carbon leakage for costs related to greenhouse gas emissions passed on in electricity prices,"* given that granted support has to be necessary and proportionate.[81]

Article 10 of the New Directive shows a swift change from the grandfathering approach towards the auctioning of allowances. Furthermore, it wishes to provide a more compatible approach with the polluter-pays principle, as 50% of revenues generated from the auction of allowances should be used for different environmental protection aims, such as investments into renewable energies, avoidance of deforestation and environmentally safe capture and storage of carbon-dioxide.[82]

In order to achieve full allocation through auctioning until 2027, a transitional period is still necessary. Under this period, a Community-wide ex-ante benchmarking has to be established that is for the provision of incentives for the reduction of greenhouse gas emissions.[83] Furthermore, 300 millions of allowances had been reserved for new entrant undertakings until December 2015.[84]

The New Directive's shift in the approach of allocation method had been welcomed, as it utilises the best available market-based instrument in terms of, compared witch allocation through grandfathering, providing the *"highest level of environmental and allocative efficiency, transparency and simplicity."*[85] Further advantage of the third phase scheme is that the Community-wide cap ensured this transparency with the abolishment of national allocation plans, the elimination of insecurity for industrial actors on the methods of allocation and the common, harmonised method on which the basis of allowances can be calculated at an EU-level.[86]

Yet even in the third phase, 40% of the total quantity is to be allocated free of charge.[87] The important question in relation to benchmarking arises in connection to selectivity. It had been outlined that the justifiability of the benchmarking system relies on the *"objectivity, the scope of the adopted standards and the degree of homogeneity of abatement cost structures."*[88] Furthermore, the benchmarking approach is less capable of causing market distortions as every undertaking are subject to the same standards in the given sectors, and that these standards reflect marginal sector abatement costs.[89]

[81] Directive 2009/29/EC, Preamble, point 27.
[82] Directive 2009/29/EC, Article 10.; Cf.: Fodor László: A CO_2 leválasztásának és tárolásának (CCS) nemzetközi vetületei, In: Raisz Anikó (edit.): *A nemzetközi környezetjog aktuális kihívásai*, Miskolc, Miskolci Egyetem, 2012, 51-61.
[83] Directive 2009/29/EC, Article 10a, point 1., para 3.
[84] Directive 2009/29/EC, Article 10a, point 8.
[85] Guendalina Catti De Gasperi: Making State Aid Control "Greener": The EU Emission Trading System and its Compatibility with Article 107 TFEU, *European State Aid Law Quarterly,* 2010/9, 797.
[86] European Commission: *European Emission Trading Scheme Handbook*, 44.
[87] Dirk Böhler: The EU Emission Trading Scheme – Fixing a Broken Promise; *Environmental Law Review*, 2013/15, 97.
[88] De Gasperi 2010, 803.
[89] De Gasperi 2010, 804.

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The issue of carbon leakage will still remain an issue to be tackled by the European legislator, as auctioning would only remain the most environmentally efficient approach, if it was applied at a global scale.[90] In such cases only those countries pose a threat, where the level of cap at national level – for example part of a regional or universal cooperation – is not defined, as if the cap imposed is sufficiently low in one state, undertakings will not relocate their production there.[91] The issue can arise from unilateral definition of caps, or from the unilateral tightening of such caps, which could be prevented by cross-border adjustments.[92] Concerning industrial sectors involving a high chance of carbon leakage, policy makers might provide some transitional support for emissions-intensive trade-exposed industries[93] that can also amount to the provision of State aid.

It is still questionable whether the allocation of allowances for free in sectors facing significant risk of carbon leakage would remain a sustainable solution. By the adoption of the New Directive, serious concerns were expressed with the further provision of free allowances, as they have the capability to affect competition in the given industrial sectors. Under the issue of carbon leakage, clearly, two huge interests collide: whether it is better to provide State aid and have undertakings within the European Union with a gradual decrease of aid involvement or to stick to the polluter-pays principle and face a larger amount of carbon leakage in the different industrial sectors.

Conclusions

All in all, it is possible to come to the conclusion that the ETS can be seen as quite a controversial scheme leaving some questions doubtful, especially if we consider the basic reconcilability of State aid measures in the area of environmental law and the polluter-pays principle. It is quite visible that State aid consideration cannot be fully aligned with the strictly interpreted polluter-pays principle. The first question that arises is to whom does the polluter pay under the ETS? As undertakings had been granted allowances freely, they could deliberately capitalise it without having to take into account environmental concerns. By selling these allowances on the market, these allowances were capable of providing a polluter pays to another polluters approach, leading to the incoherency of the ETS with environmental principles, as the income capitalised was not necessarily invested into environmental protecting investments.

The most interesting characteristic of the scheme is that it is possible to argue that this method of granting cannot be considered as a State measure, as the free allocation is defined in the Directive. Theoretically, it could be a logical argument as measures executed under EU law cannot amount to State aid. Naturally, the directive had to be implemented at national level, yet it is a question how to qualify the national allocation plans under the Directive.

[90] De Gasperi 2010, 799.
[91] OECD 2011, 174.
[92] OECD 2011, 10-11.
[93] OECD 2011, 123.

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As the NAPs are defined by the Member States on a discretionary basis that was subjected to the supervision by the Commission, it is hard to come to the conclusion that the granting of allowances is not imputable to Member States. Before the adoption of the Directive, as it has been exemplified, the Commission had accepted schemes in connection to greenhouse gas emissions on the basis of Article 107 (3)(c) due to their environmentally-friendly aims. After the adoption of the Directive, we could see a very sharp change in the Commission's approach. This swift change is attributable to the justification on the provision of free allowances at EU-level, yet with the 5% and later 10% of allowances for auctioning the Commission had been declaring NAPs incompatible with the State aid rules.

Furthermore, it is questionable whether and to what extent can the integration clause, defined under Article 11 TFEU, as environmental protection requirements must be integrated into the definition and implementation of the Union policies and activities; it plays an important role in such cases. This clause yet raises the question whether environment-specific state aid issues can be reconciled with the integration clause. If the environmental principles would be strictly followed under EU law, then it would not have been possible to grant allowances (as State aid) to undertakings. The State aid provisions in relation to the ETS can be a clear sing of the restriction of the prevalence of the integration clause. This view can be supported by Commission decisions, as before the establishment of the ETS, any aid granted to undertakings for greenhouse gas emission were considered as an aid, yet saved under paragraph (3). After the ETS Directive came into force with the free allocation, the status of the polluter-pays principle was clearly wavered, bearing the possibility of the distortion of competition in the different industrial sectors. This approach clearly shows that although environmental concerns gained significance over time, yet they are not capable of prevailing competition aspects, causing the main environmental principles and the integration clause to only have a limited significance.

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