



Brussels, 16 February 2001  
StaffA2/Peter/ECCP/Background Document 3-rev3

### CHAIRMAN'S BACKGROUND DOCUMENT 3

#### Subject: Fair competition and internal market issues

#### 3. Introduction

A number of features of the Kyoto Mechanisms, and emissions trading schemes in particular, may have a potential impact on the smooth functioning of the internal market. These features include who trades and who does not, how the trading system operates and how and how much allowances are allocated. These are not the same concerns as impacts on competitiveness *vis-à-vis* third countries. The Green Paper on emissions trading, and Section 5.2 in particular, makes a number of statements concerning the functioning of the internal market that will not be repeated in this Working Document. This document seeks to crystallise the issues and examine how an EC scheme could help. The proverbial “level playing field” will be easier to ensure with Community legislation on emissions trading, as will the optimisation of economic benefits. Ultimately, however, it comes down to a political choice whether in the context of the Kyoto Mechanisms, and emissions trading in particular, there is the political will for a more co-ordinated or, alternatively, more piece-meal approach within the EU.

The Green Paper's thesis<sup>1</sup> was that allocations to the trading sectors as a whole in each Member State should ideally be determined at Community level, whereas allocations to individual entities could be made by Member States in accordance with the Treaty's provisions and guidelines thereon. That is why the “State aid guidelines” are of such interest to this Working Group.

As a preliminary statement, it should be emphasised that emissions trading as an instrument is intended to benefit firms that do more to reduce their emissions. However, trading is also of benefit to companies that choose to reduce their emissions less (in comparison with what other policies and measures would require them to do, but without the flexibility of trading). Furthermore, other policies and measures often have unequal distributional effects on companies both within a Member State and, in the case of “Common and Co-ordinated Policies

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<sup>1</sup> See Section 7.2.1 of the Green Paper

and Measures”, on companies in different Member States. Emissions trading, in equalising the marginal cost of abatement across several Member States, would on the other hand, level competition in a way that other instruments cannot do, so that each and every company in the trading scheme faces the same price of carbon, independent of its starting position.

### **3.1 Treaty provisions and “state aid guidelines”**

The most relevant Articles of the EC Treaty include Articles 43 on the right of establishment and Article 87 on state aid. These Articles stand alongside those of the “Environment” chapter of the Treaty (Articles 174 to 176). There are other Articles of relevance, but this document will concentrate on these.

In December 2000 the Commission adopted revised Community guidelines on state aid for environmental protection, and these were published in the Official Journal C37 of 3 February 2001. Section F refers to the Kyoto Protocol and the operative paragraphs read as follows:

“70. In the absence of any Community provisions in this area and without prejudice to the Commission’s right of initiative in proposing such provisions, it is for each Member State to formulate the policies, measures and instruments it wishes to adopt in order to comply with the targets set under the Kyoto Protocol.

71. The Commission takes the view that some of the means adopted by Member States to comply with the objectives of the Protocol could constitute State aid but it is still too early to lay down the conditions for authorising any such aid.”

Earlier drafts of these guidelines were more detailed. They expressed the view that the free allocation of allowances essential for the operation of certain activities would be regarded as benefits in kind that, if limited to certain entities or sectors, are liable to constitute aid within the meaning of Article 87. The qualification as aid would depend upon a case-by-case examination.

### **3.2 The Burden Sharing Agreement and emissions trading**

This section explores what the linkages are between the Burden Sharing Agreement and the initial allocations in an emissions trading system. A series of questions are posed with a view to “warming-up” the issues discussed in the remaining parts of the paper.

The Kyoto Protocol and the Burden Sharing Agreement implicitly grandfathered emissions allowances to the EC and its Member States. Let us suppose that two countries each establish an emissions trading scheme. In country A, participants are collectively required to reduce their emissions by X% (compared to 1990), while in country B participants are collectively authorised to increase their emissions by Y% (compared to 1990). Is this inherently unfair?

“Fairness” needs to be defined. Fairness is generally understood as meaning that firms in both countries must make equivalent efforts to control their emissions. One way of defining “equivalent effort” is to say that marginal abatement costs must be equal in both countries. If trading of allowances between participants in different countries is not possible, then it is likely that marginal abatement costs will differ. However, the fact that countries have different targets does not tell us in which country marginal abatement costs will be lower. This means that the

burden sharing targets do not, on their own, give us enough information to determine whether or not they are “fair”. If trading is allowed between participants in different countries, then marginal abatement costs will be equalised across all participants. There will be a net flow of allowances from firms in the “low abatement cost” country to firms in the “high abatement cost” country. Does this mean that the “high abatement cost” country initially received an “unfair” allocation under the Burden Sharing Agreement, in spite of the fact – as already said – that the targets do not determine marginal abatement costs?

If it is felt that the “high abatement cost” country has been unfairly treated, now think of a trading scheme within a single country. Following a grandfathering of initial allocations, firms with higher marginal abatement costs will buy permits from firms with lower marginal abatement costs. Does this mean that the grandfathered allocation was “unfair”?

If the Burden Sharing Agreement is considered to be unfair, then logically any grandfathered allocation of allowances that does not equalise marginal abatement costs is also unfair. Of course, if allocation could be done in such a way that marginal abatement costs were equalised, there would be no reason for trading allowances. However, since companies have no interest to disclose all the information they possess on their options to reduce emissions and related abatement costs, neither governments nor the Commission will ever be able to implement such a “fair” allocation. Given that no basis of grandfathering of permits can in practice be perfectly “fair”, does this lead to the conclusion that the only “fair” system of allocation is auctioning?

Finally, it is to be noted that the Burden Sharing Agreement is an agreement between Member States, whereas state aid is given to entities. The Burden Sharing Agreement is a reallocation of targets within the EU in accordance with Article 4 of the Kyoto Protocol that respects the EC’s overall target of minus 8%. Its motivation is based on differentiated responsibility, and is in accordance with the principle of solidarity among the Member States.

### 3.3 Criteria for determining incompatible state aid

So when does grandfathering become incompatible state aid? What criteria will be applied to a “case-by-case” consideration? First, a few relevant clarifications should be made. “Grandfathered” allowances may have been given free, but entities may be given more than they are likely to need, or less than they are likely to need. The amount of allowances given is a key factor. **Generally, in order for grandfathered allowances not to be qualified as incompatible state aid, the allowances given to an individual entity or source should be no more than the amount of allowances than the entity or source is likely to need to cover its expected emissions (its “business as usual” path).** Such a basis for evaluation will obviously need some projection to be made of future emissions. If “business as usual” projections are being used for some, similar projections must be used for all.

Furthermore, for grandfathering not to be incompatible state aid, similar allocation rules and formula must be used for all entities or sources within any sector, or sub-sector if such differentiation is justified, operating within a particular Member State.

In essence, state aid policy should prevent the systematic favouring of particular entities or sectors by any Member State in the allocation process, without trying to be perfect.

### **3.4 Auctioning could also be a potential source of distortion**

However, it is not only allocation by grandfathering that can constitute state aid. It is quite possible that auctioning could impose a less demanding overall cap on the trading sectors as a whole than grandfathering. Auctioning could also amount to incompatible aid if more allowances were made available than the projected emissions of the sectors covered by the trading scheme. An over-supply of allowances would depress the price of allowances, which could in turn amount to a sectoral subsidy. Furthermore, auctioning may constitute state aid if, for example, access to the purchasing and holding of allowances is restricted to incumbents operating within the trading sectors in a given Member State. Having said this, however, the right of the public authority to require the retirement of allowances as fulfilment of an entity's obligations can be restricted to particular entities – because Member States have the right to oblige their entities to do things that entities in other Member States are not obliged to do.

### **3.5 Scope for differentiation in Member State regimes**

The other crucial question to be answered in respect of the internal market and fair competition aspects of emissions trading is how much scope is there for differentiation of Member State regimes? Experience in the field of taxation suggests that quite a lot of differentiation can be tolerated without undue impacts on the smooth functioning of the internal market. As has already been indicated, it is not that one Member State might grandfather and another auction that necessarily gives rise to distortions within the internal market. The two methods of allocation might be equally demanding in terms of environmental outcome and in terms of equivalent costs for firms in each Member State. If there is auctioning with full revenue recycling within the sectors covered by emissions trading, auctioning may be as revenue neutral overall as the grandfathering of allowances.

### **3.6 Partial coverage of Member States taking part in emissions trading**

What are the implications if an emissions trading scheme were to cover part but not all of the Community? Those outside the scheme may be subject to other policies and measures, or to none. Such difference of treatment may give rise to distortions of competition. However, the different policies and measures may still entail an equivalent effort on the part of entities, and therefore give rise to no advantage or disadvantage for any particular actor. On the other hand, if a particular sector in a given Member State were to be required to do nothing in terms of greenhouse gas abatement, would such indulgence constitute an incompatible aid for the sector in that Member State? Clearly, the sector would enjoy a comparative advantage *vis-à-vis* its competitors based in other Member States that may be required to do something, but is such comparable advantage incompatible state aid? Can a Member State be penalised for doing nothing, in the absence of any Community requirement to take action? State aid usually arises through the taking of deliberate action providing assistance to companies or sectors.

### **3.7 Should all sectors be treated similarly?**

One issue that was underlined during the Committee debates in the European Parliament is that fair competition and internal market arguments do not require an equivalence of effort between different sectors. Governments may deliberately choose to ask for larger contributions from some sectors than from others. Competition concerns are always between similar sectors in different Member States, just as they are between the similar sectors outside the Community. This suggests that trading need not necessarily cover all sectors, and that what matters for the internal market is that equivalence of effort is ensured within the same sectors throughout the Community. There are obviously sub-sectors of industry that compete against others: concrete is often in competition with steel in the building materials market. But concrete producers are not in competition with vehicle manufacturers. While arguments that hold good for one energy-intensive sector may also hold good for others, distortions of competition would not arise within the Community as a result of the inclusion of one sector in an emissions trading scheme and the exclusion of another very different sector.

### **3.8 Distortions between large and small sources**

A problem within an individual sector is that there may be both large sources and small. This is often problematic for other instruments of environment policy. Any threshold conferring different treatment may give rise to distortion of competition between the two categories of entity. Although the precedent for using such thresholds in EU environment policy is well established (e.g. 50MW threshold for the Large Combustion Plant Directive), there will always be difficulties if competing entities suffer different outcomes. It should be possible, however, even when using different instruments, to ensure fairness of competition. Alternatively, the use of thresholds could be avoided, but then trading would encompass both large sources and small within a given sector. In sectors such as the power generation sector, this may anticipate the likely future evolution of new capacity. Finally, even with a size threshold for mandatory inclusion in the scheme, small sources may be allowed to join a trading system voluntarily, thereby avoiding any comparative disadvantage.

### **3.9 Right of establishment and new entrants**

It should be noted that the Commission's consideration of the Danish CO<sub>2</sub>-quota system centred as much on Article 43 as on Article 87. The issue of new entrants is particularly one of market access. Whether new entrants should be required to buy their way into the market, just as they have to buy everything else that they need to set up a competing business and win market share, is still open to debate. It is generally accepted, however, that if new entrants have inadequate access to allowances that let them operate, they can be prevented from entering the market. The primary responsibility of regulators is to ensure such adequate access. This can be done a number of ways. Regular auctioning is one way that has already been discussed. Creating a sufficiently broad market is another element, so as to avoid the risk of collusion among established players. There are already Treaty provisions (Articles 81 to 86) that address the abuse of dominant positions which may be sufficient to deal with barriers to market-entry in the context of emissions trading. Furthermore, cross-sectoral and cross-border trading would facilitate market depth and liquidity – thereby largely avoiding the potential problems of

access for new entrants. Finally, the concerns about the treatment of new entrants would not appear to apply in the case of a voluntary scheme.

### **3.10 The case of “reverse discrimination”**

Some Member States may wish to apply more stringent conditions for emissions trading than may be applied in other Member States. Provided that these conditions apply equally to all businesses, whether they are national or from another Member State, a Member State may do so. This greater stringency may be by imposing more restrictive caps on emissions than other Member States (or than required by any possible future Community legislation). Alternatively, it may be claimed that the auctioning of (all) allowances by a given Member State amounts to greater stringency against entities operating within that Member State. The way to address such concerns, however, is primarily through national political processes. The Treaty does not provide recourse for businesses to seek redress against their governments on the grounds that they are being discriminated against by their own government. This is sometimes referred to as “reverse discrimination”. While it is generally seen as potentially distortionary, the Treaty does not prohibit it.

There would appear to be two ways of addressing this concern that imbalances may occur in the internal market as a result of partial coverage of an emissions trading system, or different degrees of stringency even within those sectors covered by emissions trading. The first is by ensuring equivalence of effort, however hard that might be to establish. The second is by preventing such regional differences and imposing a particular solution for the EU as a whole. While the former solution appears at first sight the more palatable, the practical difficulties of ensuring equivalence are considerable. Like benchmarking as a method of allocation, the advantages in terms of equity are likely to be undermined in terms of practicality and transparency.

### **3.11 The case for a Community instrument**

The only action that companies can seek to minimise the potential for this “reverse discrimination” is to promote greater co-ordination at EU level – whether such co-ordination be achieved through EU legislation or secured voluntarily by inter-governmental co-operation. The former option would guarantee greater certainty as well as greater uniformity on the use of emissions trading and the Kyoto mechanisms. The latter option would offer neither Member States nor companies the possibility to take legal action in the European Court of Justice under Community law.

### **3.12 Conclusion**

There would appear to be a trade off between ensuring a “level playing field” and allowing Member States to develop climate change policies along national lines. For emissions trading, the primary difference between the two approaches is essentially economic, in terms of the greater cost-reductions from an EU scheme and a more streamlined context for businesses to operate in, and political, in terms of delegation of decision-making to the EC level. However, the elimination of all inequalities between entities in different Member States is not the objective of climate change policies such as emissions trading. In the end, the issue of the

appropriateness or otherwise of an EU emissions trading scheme goes beyond the technical appreciation being made by this Working Group. Perhaps one of the key drivers for co-ordination of emissions trading within the EU will be the widely-shared wish to ensure compatibility with the Kyoto Protocol's emissions trading when that starts.