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## LEGAL POLICY BRIEFING – DRAFT ETS AUCTIONING REGULATION AND COMMISSION PROPOSAL TO MOVE BEYOND 20% GHG REDUCTIONS

### Summary and Conclusions

The Auctioning Regulation provides the EU with an opportunity to address several critical elements of climate policy at EU and national level. The European Commission should act in a way that preserves opportunities for future ambitious EU action towards a 30% target and beyond, and in a way that enables proactive Member State and civil society participation in the carbon market.

#### Set aside and cancellation of allowances – an opportunity for tightening the cap

ClientEarth considers that the Commission should not miss the opportunity in the **Auctioning Regulation** to introduce an option to set aside emission trading scheme (ETS) allowances. This would support the future transition from 20% to 30% greenhouse gas (GHG) reductions and beyond, and ensure the efficiency of the market within the existing 20% target. ClientEarth proposes an amendment to **Article 14** of the draft Auctioning Regulation that would allow a Commission decision to trigger a *delay* of the auction of some allowances to later years, with corresponding potential adjustments to the auction calendar and quantities of allowances available for auction in a given year. As the Auctioning Regulation is legally empowered to determine matters concerning the *timing* of auctions, we consider this option is viable and respects the objective of predictability required by article 10(4) of the ETS Directive.

After this set aside of allowances has been decided, a later decision would be required as to whether to auction or to cancel them. **Cancelling** the allowances is justified either as a way of tightening the cap in support of the transition to 30% GHG reductions or beyond, or simply to safeguard the efficiency of the market within existing targets. Regarding legal avenues for cancellation, the most direct legal avenue is to amend the ETS Directive. However, the current political landscape indicates that this is unlikely to occur in the foreseeable future. ClientEarth proposes an alternative option that would not require amendments to the ETS Directive. In light of jurisprudence from the European Court of Justice, the Commission could reduce the cap without any amendment to the ETS Directive, by its determination of the total quantity of allowances required to be published during 2010. This would involve considering that, by analogy to the case of *Poland v. Commission T 183/07*, the Commission is entitled to take into account up-to-date information beyond the criteria for setting the cap established by Article 9 of the ETS Directive 2003/87/EC as revised in 2009.

### Early auctions of phase 3 allowances

ClientEarth considers that while the provisions in the Auctioning Regulation for setting aside allowances would be in compliance with the ETS Directive, early auctioning of phase 3 allowances during phase 2 would not. Articles 9 and 10 of the ETS Directive circumscribe the issuing of allowances and the auctioning of those not allocated for free to the timeframe *from 2013 onwards*. Any auctioning at an earlier stage does not respect the wording of the ETS Directive.

### Civil society and citizen participation in auctions

The Auctioning Regulation has unjustifiably limited access to auctions by civil society and individuals wishing to acquire and cancel allowances to contribute to emissions reductions. This may amount to narrowing the scope of access anticipated by the ETS Directive. We propose amendments to establish additional categories of bidders for the conditional purpose of cancellation after a successful bid.

### Member State participation in auctions

The drafting and scope of **Article 18(2)** of the draft Auctioning Regulation empowering competent authorities to authorise additional categories of bidders is ambiguous and requires clarification. In particular, the Regulation must recognise the ability of all Member States (via public authorities) to participate in auctions either generally or for the purpose of cancellation. Consonant with article 193 of the Treaty on the Functioning of the European Union (TFEU) Member States can go beyond EU environmental legislation, and this should involve the ability to access allowances for the purposes of cancellation. On the current drafting, it is not entirely clear whether this ability will be confined to Member States with regulated markets and high levels of private ownership of ETS industries. Purchase and cancellation of allowances represents theoretically cost free abatement by Member States, with the revised ETS Directive providing that auction revenues will flow back to member states.

## 1. INTRODUCTION

Article 10(4) of the ETS Directive 2003/87/EC<sup>1</sup> as amended by Directive 2009/29/EC<sup>2</sup> ('the ETS Directive') requires the Commission "...to adopt a Regulation on timing, administration and other aspects of auctioning to ensure that it is conducted in an open, transparent, harmonised and non-discriminatory manner. To this end, the process should be predictable, in particular as regards the timing and sequencing of auctions and the estimated volumes of allowances to be made available."

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<sup>1</sup> 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

<sup>2</sup> 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

According to this article, the Auctioning Regulation should be adopted by regulatory procedure with scrutiny where the Commission proposal shall be sent to the Committee for its opinion, and to the Council and European Parliament which can reject it if they consider that the proposal does not comply with the content and aims of the ETS Directive, or does not respect the principles of subsidiarity or proportionality. At the time of writing, the European Commission has not submitted the final proposal to the Committee for approval. It appears that the Regulation will not meet the date of adoption (30 June 2010) required by article 10(4) of the ETS Directive.

Early versions of the Communication<sup>3</sup> on the transition from 20% to 30% greenhouse gas reductions by 2020 considered introducing a set aside of emissions trading allowances via the Auctioning Regulation, with a view of cancelling them in a later stage. The legal arguments justifying such an option, together with an analysis of the legal implications, and necessary amendments required to the Auctioning Regulation to ensure appropriate access to auctions are discussed as follows.

## 2. LEGAL AND POLICY ANALYSIS

### A. Minor amendments to Auctioning Regulation for a set aside of allowances

The Commission should not miss the opportunity of empowering the Auctioning Regulation to achieve a set aside of allowances via a mechanism to delay auction of some allowances to future years in phase 3. ClientEarth considers the legal basis for such a measure would be Article 10(4) of the revised ETS Directive and the fact that this expressly empowers the Auctioning Regulation to determine matters concerning 'timing, administration and other aspects' of auctions.

The grounds and triggers for this postponement would have to be carefully included in the Auctioning Regulation, so as not to undermine the objective of predictability required by article 10(4) of the revised ETS Directive, and enshrined by the 3<sup>rd</sup> recital of the draft Auctioning Regulation. Legally, the viability of such an approach would appear to require amendments to the Auctioning Regulation, particularly Article 14 (adjustments of the auction calendar) to introduce a requirement for all auctioning platforms to delay the auctioning of a quantity of allowances or potentially the delay of entire auctions, triggered by a Commission decision. This delay could be viewed as necessary to preserve the possibility of tightening the cap so as to achieve the desired greenhouse gas reductions by 2020.

The insertion of a new element in Article 14 here could allow for flexibility in the quantity of allowances auctioned in article 10, or the timing of auctions (article 8) whereby agreement on a set aside/cancellation would allow the Commission to publish a decision on delay of some auctions, defining quantities to be withheld and the future years in which they will be auctioned or cancelled. Such delays would have to be fairly distributed across all auctioning platforms and/or all Member States. This would be beneficial to the responsiveness of the ETS, given the need to withhold allowances within the early years of phase 3 to achieve the move to 30% reduction by 2020, and the length of the legislative procedure for the adoption of the appropriate decision.

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<sup>3</sup> Commission, *Analysis of options to move beyond 20% greenhouse gas reductions and assessing the risk of carbon leakage* COM 2010.265 (final)

Article 10(1) of the ETS Directive requires Member States "to auction all allowances which are not allocated free of charge in accordance with Article 10a and 10c." Therefore, while art 10(1) of the ETS Directive could be interpreted as a legal obstacle to cancelling allowances before auction or permanently withholding allowances from auction after the Commission has published the quantity of allowances, the Directive does not dictate the *timing* of any particular auction or quantity of allowances for auction. It follows that article 10(1) does not represent a legal obstacle to *delaying* auctions of some allowances until future years.

Similarly the linear reduction factor in article 9 of the revised ETS Directive is not a legal obstacle for setting aside allowances. Indeed, the linear factor refers to the total quantity of allowances, not the amount available for auction, and does not in real terms dictate amounts to be auctioned in any given year. We conclude that there is no legal impediment to delaying auctions of some allowances until future years, provided this is done in such a way that does not overly detract from the objective of predictability required in article 10(4) of the revised ETS Directive.

We conclude that there is nothing in the Directive that prohibits this determination of timing from *postponing* the auctioning of some of the allowances from the early years of phase 3 until a later date within the same phase of the scheme. By this time, they may be either auctioned, or cancelled if political agreement has been reached to go beyond 20% or a decision is made on the need to reduce the number of allowances for 2013 on the basis of most up-to-date information which would be additional to the criteria expressly mentioned in article 9.

#### *Potential illegality of early auctions of phase 3 allowances during phase 2*

ClientEarth considers that the anticipation of early auctions in the Auctioning Regulation (recital 19) does not comply with the content of the ETS Directive. Articles 9 and 10 of the ETS Directive circumscribe the issuing of phase 3 allowances and the auctioning of those not allocated for free to the timeframe from 2013 onwards. Any auctioning at an earlier stage does not respect the wording of the basic act. In addition, the European Commission should not anticipate early auctions which will lower the price of an already deflated price on carbon that is proving an inadequate driver of low carbon investment. Market analysts estimate the need for early auctions during 2011 and 2012 to be significantly lower than that expressed by ETS operators. Introducing further allowances into an already deflated market is unjustifiable given that the current surplus on the market achieves virtually no incentive for domestic abatement or the transition to a low emissions economy. It also goes against the objective of ensuring the efficiency of the market, and therefore runs contrary to the objectives of the ETS Directive.

Our conclusion is that while the Auctioning Regulation is empowered to decide matters of *timing* of auctions, this discretion must be within reasonable boundaries. On legal analysis of the ETS Directive, these boundaries are the start and end dates of phase 3 of the Community Scheme. Phase 3 allowances should not and cannot be auctioned during phase 2.

**Amendment:** Amend **Article 14** of the draft Auctioning Regulation, providing that a Commission decision published pursuant to this article will trigger a delay of the auctioning of a certain amount of allowances from 12 months after the date of publication of such a decision. The Commission decision would be similar to the one to be taken under Article 10 to define the estimated amount of allowances to be auctioned. The decision would define the quantity of allowances to be delayed from auction, potential delay of auctions in the calendar, and the distribution across auctioning platforms.

## **B. Legal options to tighten the cap/cancellation of allowances**

After a set aside had been achieved via delay of the auctioning of some of the allowances, these allowances could only be cancelled via an amendment to the revised ETS Directive, or the adoption of another decision via the ordinary legislative procedure. As previously mentioned article 10(1) only anticipates auctioning or allocating for free the allowances available. Therefore cancelling allowances before auction and after publication of the community-wide quantity of allowances would require amendments to the ETS Directive or a new legal act modifying the total available pool of allowances. Both would provide for the cancellation of those allowances set aside under the Auctioning Regulation, and even modify the linear reduction factor if desired. However, as it appears unlikely that political agreement on amendment to the ETS Directive will occur anytime soon, it is desirable to consider any other possible legal avenues available to the Commission within the existing ETS Directive.

As an alternative to amending the ETS Directive, the Commission could attempt to tighten the cap **for 2013** without any amendments to either the ETS Directive or the Auctioning Regulation, simply via its publication of the absolute quantity of allowances pursuant to article 9 of the ETS Directive. Article 9 of the ETS Directive 2003/87/EC as amended in 2009 requires the Commission to publish by 30 June 2010 "...*the absolute Community-wide quantity of allowances for 2013 based on the total quantity of allowances issued or to be issued by the Member States in accordance with the Commission Decisions on their national allocation plans for the period from 2008 to 2012*" (emphasis added.)

Article 9a (3) requires the Commission to publish the adjusted quantity of allowances referred to in paragraphs 1 and 2 by September 2010. This article does not determine who decides on the adjustments but it is assumed that it is the Commission that would undertake this decision. Similarly, the decision on the total Community-wide quantity of allowances will be taken by the Commission before its publication.

Depending on the interpretation of 'based on' in article 9 of the revised ETS Directive, it could be argued that the quantity of allowances issues in accordance with NAP for phase 2 represent the starting point and that it does not prevent up-to-date information from being taken into account. Moreover, article 9a requires the 1.74% linear reduction factor to already be applied to determine the Community-wide quantity of allowances issued in 2013. It was not the legislator's intention to adhere to the level of allowances from phase 2 without reduction. The requirements of the ETS Directive do not prevent the Commission from taking into account up-to-date information additional to the quantity of allowances in the NAPs for 2008-2012 and the linear factor in the determination of the absolute Community-wide quantity of allowances to be issued in 2013.

Indeed, recent jurisprudence from the European Court of Justice<sup>4</sup> in 2009 held that there was nothing in the wording of the original ETS Directive of 2003 or the nature or the objectives of the system that would prevent Member States from modifying their data in National Allocation Plans (NAPs) and therefore modifying the cap to take account of new information received. Moreover, the Court recognised that Member States have the right to carry out subsequent adjustments after the adoption of their individual allocation decision, even if this is not expressly mentioned in any of the provisions of the ETS Directive. The Court also stated that the Commission is required to permanently ensure that the NAPs take account of the most exact and thus the most up-to-date information possible “in order to cause the least damage to economic development and employment while maintaining an efficient system of greenhouse gas emission allowances.” This latter requirement was not based on any requirements or criteria for national allocation plans established in Annex III of the ETS Directive as amended in 1996 in relation to Article 9(1).

Therefore, it is conceivable that this principle could be applied by analogy to the new phase of the ETS Directive, informing the interpretation of the words ‘based on’ in article 9, and argue that the Commission has the responsibility to take into account latest up-to-date information in its determination of the total quantity of allowances, and the subsequent estimate of the amount to be auctioned. Pursuing this line of reasoning, the Commission would be entitled to adjust the cap/the Community-wide quantity of allowances for 2013 by taking into account new information. This new up-to-date information could include new data on real emissions, the new PRIMES 2009, and the general recognition that surplus allowances are leading to a deflated price in carbon, and are failing to drive necessary investments towards a low carbon economy. Furthermore, article 1 of the ETS Directive recognises that a primary objective of this legislative act is increasing the reduction of greenhouse gas emissions so as to contribute to the levels of reductions that are considered scientifically necessary to avoid dangerous levels of climate change. The most recent scientific information indicates that the data that was used to inform the level of ambition of the climate and energy package was not complete and will not lead the planet to safe atmospheric concentrations of greenhouse gases.

We consider that the jurisprudence from the European Court of Justice concerning modification of the ETS cap has significantly altered the landscape, notwithstanding the fact that the case law in question concerned phase 2 of the scheme. We consider that the pronouncements of the Court of Justice support the ability of the Commission to adjust the cap on the basis of the most up to date information in order to achieve the objectives of the ETS Directive, including required environmental GHG reduction benefits and to ensure the efficient functioning of the carbon market. It is important to note that the Court held that Member States were allowed to alter the cap in their NAPs *without* any express legal basis for such adjustments in the ETS Directive 2003.

The Court of Justice also recognised the Commission as the body charged with ensuring that the Community-wide quantity of allowances takes account of the most exact and thus the most up-to-date information possible “in order to cause the least damage to economic development and employment while maintaining an efficient system of greenhouse gas emission allowances.” The only mechanism for the Commission to carry out this role is by recognising the possibility to take into account up-to-date information while defining the Community-wide quantity of allowances issued each year starting in 2013.

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<sup>4</sup> Poland v. Commission T 183/07 paragraphs 114 to 119 and the jurisprudence mentioned in it – UK v. Commission Case T/178/05 and Germany v. Commission Case T-374/04

Similar arguments could potentially also apply to the quantity of allowances to be issued each year from 2013 onwards. There is some uncertainty regarding the publication of the absolute Community-wide quantity of allowances for the years subsequent to 2013. From the ETS Directive, it could be interpreted that there will be no publication and assume that the quantity of allowances to be issued each year would automatically be the one for the previous year minus the 1.74% linear factor. However, from reading the Directive in combination with the draft Auctioning Regulation, we can assume that the Commission will publish every year the Community-wide quantity of allowances to be auctioned, and that amendments to this quantity could be allowed.

In any case, it is arguable that in the previously mentioned case law, the European Court of Justice has recognised that the Commission may intervene and take account of latest information to adjust the cap to ensure the efficiency of the market. This potential ability is supported by the fact that in phase two Member States were allowed by the Court of Justice to do so (with no express legal basis,) but also because the Court of Justice recognised the Commission as the body charged with ensuring that the Community-wide quantity of allowances takes account of the most exact and thus the most up-to-date information possible.

### **C. Access to auctions by civil society, and post-auction cancellation mechanisms.**

The Commission has expressed that all actors, including individuals should play their part in climate mitigation.<sup>5</sup> Legal entities and in particular SMEs are also mentioned in the ETS Directive and the Auctioning Regulation. However, unless a voluntary cancellation mechanism post-auction, and/or enhanced access to auctions is built into the Auctioning Regulation, realistic options are to some extent limited for individuals and public interest organisations to make any direct impact or contribution to reduce emissions within the traded sector. Currently emissions saved by reduced demand in the traded sector result in a freeing up of emissions that are able to be passed on to other sectors or banked for future years unless operators decide to cancel allowances according to article 12 (4) or an adjustment of the ETS cap would be introduced.

We submit that the draft Auctioning Regulation has narrowed the access that may have been envisaged by the ETS Directive. Article 19(2) of the ETS Directive 2003 established that *any* person may hold an emissions allowance. Once held, article 12 provides that allowances may be cancelled at any time at the request of the person holding them. The essence of this provision is unaltered by the move to centralised allocation in phase 3, following the ETS Directive 2009. Yet the ability for any person to obtain and cancel an allowance is limited by the current draft Auctioning Regulation, which denies easy and effective access for the purposes of voluntary cancellation in the early years of auctioning and does not guarantee that the categories will ever be expanded in the future. The options that remain include paying a financial institution, or finding a seller on the secondary market, both of which may be dissuasive and may represent unnecessary costs and limitations.

The draft Auctioning Regulation aspires to create open access to auctions in order to encourage participation and competitive auction outcomes (recital 21). The elements of article 18 strive to strike a balance between open access and protection of the market from various forms of market

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<sup>5</sup> Decision 406/2009/EC on the effort of Member States to reduce their greenhouse gas emissions to meet the Community's greenhouse gas emission reduction commitments up to 2020 (effort sharing decision) , 29<sup>th</sup> recital

abuse, by limiting access to easily identifiable participants. However, it is worth noting that several concerns about market abuse and financial crime either do not apply to situations where participants have a legitimate interest in purchasing allowances for immediate cancellation and corresponding CO<sub>2</sub> reductions, or can be overcome. Legal analysis of the ETS Directives reveals there to be no legal impediment to allowing permits to be auctioned for the express purpose of immediate or prompt cancellation. Indeed, in their purest form, auctions are designed to facilitate the flow of capital to where it is valued most, and on an analysis of the ETS Directive, this includes where they are valued for the purposes of cancellation to remove additional allowances from the system.

Despite the fact that individual purchases are unlikely to amount to a sizeable portion of allowances, there is some climate benefit from building in post-auction cancellation mechanism into the Auctioning Regulation, offering a simple way of reducing emissions within the established cap. In the current ETS system voluntary emission reductions on the demand side of the economy make no direct impact on emissions during a given scheme phase, and simply free up permits that are able to flow to other sectors of the traded sector, unless the cap would be adjusted according to the reductions or the holder of the allowance request to cancel them according to article 12(4) of the ETS Directive.

The Community law principle of proportionality, as defined in the Impact Assessment to the Auctioning Regulation, requires that community legal measures are commensurate with their purpose.<sup>6</sup> Shutting down access to certain categories of bidders where there is no legitimate risk of market abuse is not proportionate, and does not constitute 'fair and open access' as required by article 10(4) of the revised ETS Directive. Persons or bodies bidding for the purpose of immediate cancellation constitute a separate category<sup>7</sup>, where the 'know your customer'<sup>7</sup> concerns do not apply to the same extent for this situation. Provided the necessary measures are in place, there is not sufficient reason to exclude these individuals or public interest NGOs from auctions. Furthermore, ClientEarth notes, that this degree of stringency does not apply to the secondary market, whereby individuals may acquire and trade in permits. This is another reason that the denial of access to civil society may be unjustifiable.

### *Sandbag case study*

Sandbag is a Community Interest company registered in England and Wales.<sup>8</sup> It is a NGO whose primary activity involves buying EU emissions allowances on behalf of civil society and cancelling them to effect emissions reductions. Article 18(1) does not guarantee Sandbag access to auctions under phase 3. Article 18(2) may allow the UK discretion to extend authorisation to Sandbag in the future, but provides no assurance this will ever occur. Furthermore, the language of article 18(2) is somewhat ambiguous as to whether the conditions in 18(2) apply to an

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<sup>6</sup> Commission Staff Working Document, *Impact Assessment accompanying document to the Commission Regulation on the timing administration and other aspects of auctioning of greenhouse gas emissions allowances pursuant to Article 10(4) of Directive 2003/87/EC* at 36.

<sup>7</sup> 'know your customer' is the language employed in the Impact Assessment, above n3 at page 11. This refers to the need purported need to limit access to easily identifiable customers, with recognised interests in accessing auctions.

<sup>8</sup> [www.sandbag.org.uk](http://www.sandbag.org.uk)

organisation such as Sandbag, or would exclude Sandbag from being authorised without jumping through further accreditation and financial verification hoops which may deter or make impractical the continuation or expansion of this public interest activity.

As auctioning becomes the norm rather than the exception for allocation during phase 3, Sandbag's options to continue their work are likely to be limited to finding sellers or donors in the secondary market willing to sell at a fixed price, provided they meet any access rules required for the regulated secondary market in each member state. Despite the fact that the secondary market will be the larger pool in the near future, this exclusion from auctions represents an unnecessary limitation on options to acquire permits. Furthermore, it may at times be financially and practically dissuasive to find sellers on the secondary market, particularly at times when the price of carbon on the secondary market is higher than primary auctions. The easy access established by the Auctioning Regulation, including by internet, may make auctioning a practical and attractive option for civil society.

Alternatively, Sandbag may go through a financial institution to access auctions. Clearly, this will be a less attractive option as will involve 'paying twice.' In this way, articles 18 and 19 run contrary to the principle of equal treatment given that bidding for the purpose of immediate cancellation is a legitimate interest anticipated by the Directive, that does not pose the same risk of financial crime provided the Regulation requires the auctioning platform to ensure the necessary checks and balances. This appears to be unjustifiable, particularly given that purchase for the purpose of immediate cancellation does not pose the same threat of market abuse that exists for bidding for trade.

*Ambiguity in the text and scope of article 18(2) – potential for member states to authorise additional categories of participants*

Article 18(2) provides a possible exception to the lack of access by other categories of bidders such as civil society. This provision leaves the door open for competent authorities in member states to expressly authorise other categories of participants who meet the conditions in article 18(2). Recital (21) explains the intention of limiting eligibility to auctions to certain pre-defined categories, without precluding the possibility of enlarging access to additional categories further down the track. It is therefore possible that this provision empowers competent authorities in member states to grant access to NGOs trading in their own accounts, provided they comply with any necessary conditions pursuant to article 18(2)(c).

If the individual or NGO was trading in their own account, the condition in Article 18(2)a) would not seem to apply, this being directed towards bidders bidding on behalf of others. However, condition 18)(2)b) limits future authorisation to persons who have complied with the requirements of the *Directive on Preventing the use of the Financial System for the Purposes of Money Laundering and Terrorist Financing*,<sup>9</sup> which, although sounds unlikely, could (potentially), capture individuals or NGOs where bids exceed 15,000 euros<sup>10</sup>. Given the minimum size of 500 allowances per bid, (article 6), this threshold will be exceeded. Accordingly, **ClientEarth submits that the language of Article 18(2) would benefit from clarification of whether the conditions (a) to (c) apply to all potential new categories or only those**

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<sup>9</sup> Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing.

<sup>10</sup> Article 2)3)e) Directive 2005/60/EC

**bidding on behalf of clients**, and should affirm in recital (21) that potential additional categories include NGOs bidding for the purpose of immediate cancellation for climate/CO<sub>2</sub> reduction purposes.

However, it is important to note that, as concerns individuals, the balancing of market protection concerns in the recitals of the Regulation **make it extremely unlikely that Member States will ever open general access to individuals, unless a mechanism is inserted into the Regulation providing open access for the conditional purpose of immediate cancellation for CO<sub>2</sub> reduction purposes**. Depending on the domestic laws of each member state, this could be achieved by a simple declaration/authorisation signed by the participant prior to entry to an auction authorising the immediate transfer/cancellation of the permits following a successful bid.

*No legal impediment to including a voluntary cancellation mechanism in the Auctioning Regulation*

Article 10(1) of the revised ETS Directive requires that all allowances not allocated for free in accordance with Article 10(a) and c) shall be auctioned. Even if this prevents Member States (or the commission in the case of joint auctioning platforms) from cancelling allowances prior to auctioning them, **it does not impose any limitations on the purposes for which they may be auctioned**. Article 19(2) of the ETS Directive established that any person may hold an emissions allowance. Once held, Article 12 provides that allowances may be cancelled at any time at the request of the person holding them. It follows that there is no legal impediment to establishing additional categories of participant (Article 18) or admission to bid (Article 19) for the conditional purpose of immediate cancellation following the auctioning process (i.e. the successful bid.) In this scenario all legal requirements of the auction, (bidding/payment/transfer of title) have been satisfied. In practice this could be achieved in a number of ways, including potentially by a declaration prior to bidding that the participant authorises the transfer of title to the auctioning platform to cancel the permit on their behalf immediately after the successful bid or transfer of title, or mechanisms to allow and require the successful bidder to cancel the newly acquired allowances immediately after transfer of title. The technical arrangements could certainly be left to individual auctioning platforms to be decided after the enactment of the Regulation.

**Amendments:** consider introducing additional 'open' category of bidder in Article 18, where bidding is for exclusive purpose of immediate cancellation. Then amend Article 19 (admission to bid) to establish a mechanism whereby the auctioning platform ensures the necessary administrative and legal arrangements to ensure the potential bidders authorise and accept the terms of their admission will result in cancellation of the allowance. This could be achieved by the signing of a declaration appropriate to the contractual or property laws of the relevant member state.

## **D. Access and cancellation mechanisms – member state governments and public bodies**

The over allocation during phase two has been well documented. Combined with impacts from the economic recession, and large scale partial closures not accommodated within allocation methodologies, the carbon market is deflated and failing to drive necessary investments in low carbon technologies or the shift to a low carbon economy.

There are several reasons why member state governments have legitimate interests in accessing auctions. One of these includes to take account of voluntary emissions reductions by civil society. Emissions trading schemes in other jurisdictions have recognised the value of enabling voluntary action on the part of civil society or governments as a way to open up the 'ceiling' established by cap and trade models. As a recent related example, in the proposed Australian Carbon Pollution Reduction Scheme Bill of 2009, the Australian government committed to cancel emissions units in accordance with collective household action such as switching to renewable electricity providers<sup>11</sup>.

Introducing cancellation mechanisms following successful bids into the Auctioning Regulation could potentially offer legitimate avenues for removing amounts of allowances from the system, particularly in scenarios where member state governments agree to buy and cancel allowances in accordance with emissions saved by households within the traded sector. In accordance with the proportionality principle, and article 193 of the TFEU, member state governments should have the opportunity to access auctions either for the purposes of buying and cancelling in accordance with emissions savings deriving from voluntary action of their citizens, or in exercise of their right to adopt more stringent CO<sub>2</sub> measures. It *appears* that article 18(2) of the Auctioning Regulation will empower member states to authorise public agencies to participate directly in auctions, however, reading the Regulation as a whole, it would be desirable to clearly affirm and clarify the scope of article 18(2) regarding direct access by public bodies. It is acknowledged that this option would only be viable if auctioning platforms are truly independent from government bodies that would be authorised to purchase and cancel on behalf of member states.

On the current drafting, only public bodies exerting commercial control over ETS operators are guaranteed the option of accessing auctions. This could potentially create unequal opportunities for state acquisition of allowances in member states with high levels of public ownership, compared to states like the UK which is a deregulated market.

**The option for Member States to easily obtain and cancel allowances may be an important way of giving effect to article 193 of the TFEU and the ability of member states to go beyond the level of environmental protection established by EU legislation.** While there do not *appear* to be any direct legal obstacles to member states using article 18(2) to grant themselves access in the text of the Regulation, the prohibition on admitting any person who is in a position to exercise, directly or indirectly, influence over the management of an auctioning platform (article 18(5)d) could discourage the use of Article 18(2) to allow departmental or public bodies access. In general, the drafting of Article 18(2) is unclear

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<sup>11</sup> Australian Government *Details of Proposed CPRS Changes*, 24 November 2009, page 17 available at: <http://www.climatechange.gov.au/government/initiatives/cprs/~media/publications/cprs/CPRS-Implementation-of-Nov09-changes-pdf.ashx>

and requires amendment. On the current drafting, there is a risk that this option will only be open to certain member states that have regulated markets and high levels of public ownership, and where governance arrangements allow the government in question to direct the public body to purchase and cancel permits. (Article 18(1)e). This could create inequity for countries that do not have public ownership or commercial control over ETS operators.

*Theoretically cost free abatement by member states*

A particularly interesting aspect of a scenario where member state governments purchase and cancel permits is that of cost. While at first glance cost would appear to be prohibitive to any significant governmental purchase of allowances, it must be remembered that revenue from auctions flows back to Member States (article 10(3) of revised ETS Directive). **Thus, theoretically, the cost of governmental purchase of any emissions allowances would be neutralised as the cost that a public body encountered following a successful bid would flow back to the member state in accordance with article 38 of the draft Auctioning Regulation.** This of course does not factor in any indirect costs (or increases in the value of auctioned allowances) arising from increasing scarcity of allowances. Nevertheless, as regards governmental purchase and cancellation in accordance with voluntary action on the part of civil society (e.g. collective switch to renewable electricity providers), it is important to appreciate that this is a cost free form of abatement for member states.

It is acknowledged that member states may wish to cause government agencies to bid for the purpose of cushioning installations within their traded sector from price spikes or other unanticipated circumstances raising the cost of abatement, and this may result in undesirable market distortions with negative climate impact. For this reason greater access is only advocated for the exclusive and conditional purpose of cancellation.

**Amendments:** Simple amendments to article 18(2) are needed, clarifying and affirming that the scope of this provision legally empowers member states to authorise themselves (public bodies, government representatives or ETS competent authority) to participate in auctions generally, or for the express purpose of immediate cancellation. A simple addition to one of the recitals would suffice to anticipate access to auctions by all member states. Alternatively, as already discussed, a simple amendment to articles 18(1) and 19 could establish an additional 'open' category of participant guaranteed access where admission to bid is conditional upon immediate transfer and cancellation of the permits if the bid is successful.

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