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Consistency between the Granting of State Aid and the Polluter-Pays Principle: Aid Aimed at Mitigating Climate Change

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Abstract

Since 2009, the EU ETS Directive set up a general rule for the auctioning of emission allowances. It is subject to a number of exemptions. The transitional allocation of free allowances in the electricity sector, and in general the granting of free or below-market-price allowances, are caught by the TFEU prohibition on grants of state aid. However, the EU legislature and its executive—the European Commission—are empowered to grant the EU member states exemptions in order to correct market failures. At face value, such arrangements seem to run contrary to the polluter-pays principle on account that state aid subsidizes emissions of greenhouse gases instead of internalizing their costs into the price of goods and services delivered by the recipient installations. This article explores how such arrangements amount to state aid and analyses the manner in which the exemptions are consistent with the polluter-pays principle.

Keywords

EU ETS – free allocation of emission allowances – prohibition of state aid – polluter-pays principle

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1 Introduction

The urgency of the climate change challenge means that the transformation to a low-carbon economy requires significant government intervention to drive change at the necessary pace and scale.[1]

The Europe 2020 strategy sets forth three headline targets for climate change and energy sustainability:

- A 20 per cent reduction in Union greenhouse gas emissions compared to 1990 levels.
- An increase in the share of Union energy consumption produced from renewable resources to 20 per cent;
- A 20 per cent improvement in the EU's energy efficiency compared to 1990 levels.

These targets were revised upward by the European Council in October 2014.[2] The key targets for 2030 are:

- Reduction in greenhouse gas emissions of at least 40 per cent from 1990 levels.
- A share for renewable energy of at least 32 per cent.
- An improvement in energy efficiency from 1990 levels of at least 32.5 per cent.

At the end of 2019, the European Council—with the exception of Poland—agreed on an even more ambitious decarbonization strategy.

State aid in the environmental and energy domains constitutes one of the spearheads of national environmental protection policies and the fight against global warming. First, given the costs of investments borne by the private sector in order to comply with the different directives fleshing out the EU climate change and energy sustainability objectives, public authorities are inclined to give financial assistance to their installations emitting greenhouse gases. EU institutions are to some extent authorizing the granting of such aid in order to compensate the recipient installations for costs incurred by the implementation of EU standards.

Second, state aid is granted with a view to encouraging regulated entities to be at the forefront of technological innovation in greenhouse gas emission abatement and in the development of alternative energy sources. Containing measures that are both 'positive' (subsidies, loans, direct investment, etc.) and

1 Green European Foundation and the Greens/EFA Group, *The Role of State Aid in Creating a Green Economy* (Belgium, 2013).

2 Commission Communication, *A policy framework for climate and energy in the period from 2020 to 2030*, COM/2014/015 final.

'negative' (tax relief, preferential tariffs, tax remission, exemption from the obligation to pay fines or other pecuniary penalties, guarantees, etc.),[3] these forms of aid can be quite varied. However, some aid may benefit national recipients to the detriment of competitors and, for this reason, undermine the system of free and non-distorted competition required by EU law. Since 1957, the granting of state aid is strictly controlled in the EU. In order to prevent state aid from distorting competition in the internal market and affecting trade between member states in a way that is contrary to the common interest, Article 107(1) of the Treaty on the Functioning of the European Union lays down the principle that state aid is prohibited, as well as the conditions under which it may be authorized by the Commission. In order for a measure to be considered in breach of Article 107, it is necessary to provide evidence, first, that it amounts to state aid as defined by this provision, and, second, that it does not fall under any of the exceptions listed in paragraphs 2 and 3 of the Article. These exceptions are premised on the recognition that market failures need to be corrected with state monetary interventions. This would hold true in the case of the environmental externalities that are not fully integrated into the pricing of goods and services.

Account must also be taken of the fact that a number of subsidies falling within the scope of TFEU Article 107 are also likely to hamper environmental policy. A case in point is the overallocation of greenhouse gas emission allowances. By way of illustration, in 2006, member states overallocated carbon allowances free of charge to a number of major polluters. This led to a collapse of the price of the allowances and endangered the whole trading scheme; in addition, the windfall profits caused a significant distortion in competition.[4] Last but not least, such an overallocation may sit awkwardly with the polluter-pays principle (PPP), enshrined in TFEU Article 192(2), which requires polluting entities to bear the costs of their pollution-reduction investments.[5]

This article is structured as follows. Section 1 explains briefly how the EU ETS is likely to empower member states to grant state aid to their regulated entities. Section 2 explains how TFEU Article 107 on state aid may apply to the EU ETS. Section 3 addresses the paradox created by the granting of state aid in accordance with the EU ETS and the Treaty's PPP provision that requires the internalization into the prices of products of climate change externalities.

3 Case C-126/01 *GEMO* [2003] ECR I-4397, para. 28.

4 Due to this overallocation, the price of allowances fell in one month from almost €30 to €12. E.g. J. de Sépibus, 'Scarcity and Allocation of Allowances in the EU Emissions Trading Scheme: A Legal Analysis', *NCCR Trade Working Paper 2007/32*, 36.

5 See N. de Sadeleer, 'The Polluter-Pays Principle in EU Law: Bold Case Law and Poor Harmonisation', in *Pro Natura: Festskrift til H.-C. Bugge* (Oslo, Universitetsforlaget, 2012), 405–19.

Following a brief summary of the status of the PPP in EU law (Section 3.1), I consider its role in state-aid law (Section 3.2).

2 EU ETS

The EU ETS Directive 2003/87/EC (ETS Directive) establishes a trading market in greenhouse gas emission allowances from certain industrial sectors.[6] Its purpose is to establish an efficient European market in greenhouse gas emission allowances, with the least possible diminution of economic development and employment. Accordingly, the reduction of greenhouse gas emissions 'must be achieved, in so far as possible, while respecting the needs of the European economy'.[7]

The ETS Directive has been hailed as the cornerstone of the EU's policy to combat climate change by providing a flexible scheme for reducing greenhouse gas emissions cost-effectively. The ETS applies to some 11,000 power stations and other large-scale industrial facilities and covers around 45 per cent of the EU's total emissions. Still in its third phase (2013–2020), a single EU cap on emissions (reduced each year by 1.74%) applies in place of the previous system of national caps.[8] Auctioning is the default method for allocating allowances. However, in sectors other than power generation, the transition to auctioning is taking place progressively. Some allowances continue to be allocated for free until 2020—and beyond. Whether the allowances are granted freely, sold, or auctioned, the regulated entities can trade in the intangible assets representing market value for a specific period. It follows that they enjoy the advantage of being able to monetize the economic value of the allowance.

The free allocation of allowances aims at shielding internationally competing industrial installations from being exposed to a significant risk of carbon leakage. In effect, some entities may consider transferring their production outside the EU where industry is not subject to comparable emission constraints. To address this risk of carbon leakage, the ETS Directive calls on the Commission to determine a list of sectors and subsectors deemed to be exposed to a significant risk of carbon leakage and entitled to receive free

6 Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the Community [2003] OJ L275/32.

7 Case T-178/05 *G.B. v. Commission* [2005] ECR II-4807, para. 60.

8 Previously, the ETS required member states to draw up National Allocation Plans (NAPs) for each trading period. NAPs set the total amount of greenhouse gas that can be emitted by all the installations in each country covered by the scheme, as well as the number of emission allowances allocated to each individual installation.

allowances.[9] The Commission's decision in this respect lists a variety of industrial installations that, among others things, produce textiles, plaster, bricks, tiles and construction products, cast iron and light metals, spirits, different categories of paper, etc. Companies operating these installations may decide to shift their production because they cannot pass on the ETS-related cost increases to their customers without significant loss of market share. Accordingly, recipients of the free allowances receive special treatment to support their competitiveness in a global market.

For each installation belonging to one of these sectors or subsectors, the amount of free allocation is calculated based on a formula whereby its production quantity (in tonnes of product) is multiplied by the benchmark value for that particular product (measured in emissions per product tonne). Since the benchmarks are based on the performance of the most efficient installations, only those installations in each sector receive enough free allowances to cover all of their needs. For installations in other sectors, not on the carbon-leakage list, free allocation is reduced every year across phase 3—starting from 80 per cent in 2013 to reach 30 per cent in 2020.

Furthermore, Article 10(a)(6) of the ETS Directive empowers member states to compensate the most electricity-intensive sectors for increases in electricity costs as a result of the EU ETS, through national state-aid schemes. These special and temporary measures involve state aid within the meaning of TFEU Article 107(1). In accordance with TFEU Article 108, this state aid must be notified by member States to the Commission and may not be put into effect until it is approved by the Commission.[10] The maximum aid amount that member states can grant to the operators of these installations must be calculated according to a set formula. Furthermore,

> in order to minimise competition distortions in the internal market and preserve the objective of the EU ETS to achieve a cost-effective decarbonisation, the aid must not fully compensate for the costs of EUAS [European Union Allowances] in electricity prices and must be reduced over

9 The first list of sectors and subsectors deemed to be exposed to a significant risk of carbon leakage was established in 2014. See Commission Decision 2010/2/EU and Commission Decision 2014/746/EU determining a list of sectors and subsectors which are deemed to be exposed to a significant risk of carbon leakage, for the period 2015 to 2019, OJ L 308, 29.10.2014, pp. 114–24.

10 Where the aid has been implemented without the prior approval of the Commission, in breach of the notification requirement, it will be regarded as unlawful.

time. Degressive aid intensities are fundamental in operating State aid to avoid aid dependency.[11]

The question whether tradable permit allocations by member states under the ETS Directive, amount to state aid has been dogged by controversy. It is as much about the reasoning as about the concrete results for administrative practice.

3 State-aid Law and the Granting of Tradable Emission Rights

3.1 *Scope of State-aid Law*

TFEU Article 107 does not provide a definition of the concept of state aid. Measures falling under this provision are not identified with reference to their form, objectives, or activities to which they apply. According to settled case law, in order to be classified as state aid, a measure must satisfy four conditions.[12] For clarity, the conditions set out by the Court of Justice of the EU (CJEU) are examined here in a slightly different order:

– an advantage must be conferred upon the recipient of the aid;
– the advantage must be of state origin;
– the aid must have a selective nature; and
– the aid must be liable to affect trade between the member states.

These conditions often end up becoming entangled, which highlights the evolutionary and pragmatic nature of the concept of state aid. This section attempts to set the scene by explaining how the free grant of tradable emission rights fulfils these criteria.[13]

11 Commission Guidelines on State aid for environmental protection and energy 2014–2020, OJ C 200, 28.6.2014, para. 12 [hereinafter 2014 guidelines].

12 Case C-142/87 *Belgium v. Commission* [1990] ECR I-959, para. 25; Joined Cases C-278–280/92 *Spain v. Commission* [1994] ECR I-4103, para. 20; Case C-482/99 *Stardust* [2002] ECR I-4397, para. 68; Case C-280/00 *Altmark* [2002] ECR I-7747, para. 74; and Case C-345/02 *Pearle and Others* [2004] ECR I-7139, para. 32.

13 For a general overview of the application of these criteria to environmental measures, see P. Thieffry, *Droit de l'environnement de l'UE*, 2nd ed. (Bruylant, 2011), 963–87; S. Kingston, *Greening EU Competition law and Policy* (Cambridge University Press, 2014), 379–434; N. de Sadeleer, 'State Aids and Environmental Measures', 1 *Nordic Journal of Environmental Law* (2012), 3–30 ; and idem, *EU Environmental Law and the Internal Market* (Oxford University Press, 2014), 435–67.

3.1.1 First Condition: an Advantage is Conferred on the Recipient through the Grant of Tradable Emission Rights

Does the grant of tradable emission rights entail an advantage? Account must be taken of the fact that under the EU ETS some emission rights are granted free of charge (by grandfathering) whereas others are sold or auctioned. During the first two phases (2005–07 and 2008–12), the ETS Directive allowed member states to auction off a limited number of allowances (5–10 per cent). As a result, 90–95 per cent of the allowances were granted free of charge. In the course of the third phase, as noted above, the ETS Directive still provides for free allocation,[14] even though allowances to emit greenhouse gases have been auctioned off since 2013.[15]

Where the distribution of allowances involves grandfathering, or where they are sold by state authorities below market price, there is an advantage for the recipient entity: 'the advantage flows essentially from the fact that the state has handed out for free something that is tradable'.[16] In its 2001, 2008, 2012, and 2014 guidelines, discussed later, the Commission took the view that tradable-permit schemes may involve state aid in various ways, for example, when member states grant allowances below their market value and this is imputable to member states.[17] In fact, the mere existence of windfall profits is an argument for the recognition of an economic advantage conferred on the recipient entity.

Nevertheless, the Commission did not request that the National Allocation Plans be notified as state aid under TFEU Article 108(3).[18] In a joint letter from the Directors-General of DG Environment and DG Competition to member states, dated 17 March 2004, on the subject of 'State Aid and [NAPs]', the

14 Pursuant to Art. 10c(1) of the ETS Directive, until 2020 certain member states are allowed to grant allowances free of charge to installations for electricity production. See Commission Communication, Guidance document on the optional application of Article 10c of Directive 2003/87/EC [2011] OJ C99/9.

15 See ETS Directive 2003/87/EC, Art. 10(1); and preamble to European Parliament and Council Directive 2009/29/EC amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community [2003] OJ L140/63, recital 19.

16 J. H. Jans and H. Vedder, *European Environmental Law*, 4th ed. (Europa Law, 2008), 321.

17 See 2001 Commission guidelines, paras 55 and 139; Commission, Guidelines on Certain State Aid Measures in the context of the greenhouse gas emission allowance trading scheme post-2012 [2012] OJ C158/4. See M. Stoczkiewicz, 'Free Allocation of EU ETS Emission Allowances to Installations for Electricity Production from a State Aid Law Perspective', 3(3) *Environmental Economics* 99–107 (2012).

18 Case T-387/04 *EnBW Energie Baden-Württemberg AG* [2007] ECR II-1201. See also Commission Decision on the first French NAP C(2004) 3982/7 final; and Commission Decision on the first Polish NAP C(2005) 549 final. It should be noted that the Commission has never opened a formal state-aid investigation.

Commission set out the procedures to be followed and the criteria which it intended to take into account in assessing possible state aid granted in the context of the implementation of NAPs in accordance with the criteria laid down in Annex III to the ETS Directive.

In assessing the validity of the plans under the ETS Directive, the Commission reminded the applicant member states that it was not excluded that their NAPs implied state aid. In that 2004 letter, the Commission recalled that in its previous assessment of different NAPs that were adopted prior to the entry into force of the ETS Directive, it had concluded that the four criteria laid down in TFEU Article 107(1) had been fulfilled. In those decisions, the Commission had considered that an emission allowance was equivalent to an intangible asset, the value of which was determined by the market, and that, therefore, the fact that the state gave it to regulated entities free of charge gave them an advantage; that by not selling the allowance, for example by auction, the state deprived itself of a resource, with the result that such an advantage implied a transfer of state resources; and that the advantage at issue was selective, affected trade between the member states, and distorted or could have distorted competition.

In its 2004 letter the Commission considered that the NAPs adopted in accordance with the requirements laid down by the ETS Directive may contain elements that distort competition and constitute state aid. It indicated that such was the case, for example, where a member state allocates more allowances to installations than were needed to cover their projected emissions during the allocation period, since those emitters could sell the surplus allowances and retain the proceeds of the sale. It also pointed out that such an advantage could seriously distort competition, and since there would be no link to an environmental counterpart, it would consider whether the state aid at issue is incompatible with the common market. The Commission therefore pointed out that if it discovered that a NAP favoured certain entities in that manner, it would initiate a state-aid proceeding on its own initiative.

Finally, the Commission indicated in its letter that it would not require formal notification of NAPs under TFEU Article 108(3) but would review NAPs notified to it under the ETS Directive.

3.1.2 Second Condition: State Resources

To be classified as state aid within the meaning of TFEU Article 107, the advantage must be, first, granted 'directly or indirectly through State resources and, second, be imputable to the State'.[19] These conditions are cumulative. Accordingly, the concept of 'aid' is defined in particularly broad terms in that it

19 Case C-482/99 *Stardust* [2002] ECR I-4397, para. 24; and *GEMO*, above, para. 24.

applies to all forms of assistance granted by a member state or through state resources in any form whatsoever.

As a starting point it should be stressed that the measure must be imputable to the member state. The fact that an EU act, such as the ETS Directive, authorizes member states to allocate greenhouse gas emission allowances free of charge does not prevent the allocation from being qualified as state aid, considering that the national authority is endowed with sufficient room for manoeuvre when implementing the directive. The ETS Directive indeed offers national authorities much discretion during the first two phases of the scheme (2005–07, 2008–12). In the course of the third phase (2013–20), this second condition is easily fulfilled with respect to a free allocation of allowances granted to entities exposed to a significant risk of carbon leakage.

Second, the advantage must be granted 'directly or indirectly through state resources'. The scope of this condition raises a number of questions with respect to cap-and-trade schemes. It must be noted at the outset that measures that do not entail direct or indirect financial burdens for the state do not normally fall within the concept of state aid, even where they represent an advantage for the regulated entities.

By way of illustration, in *Preussen Elektra* the CJEU found that, even though it gave some economic advantage to producers of renewable electricity, the obligation imposed by German law (the *Stormeinspeisungesgesetz*) on private electricity companies to purchase electricity from renewable resources in their region at a higher price than the electricity's economic value did not involve a transfer of state resources. In other words, the obligation to purchase electricity produced from renewable sources at minimum prices did not involve a direct or indirect transfer of state resources to the electricity production companies.[20] Hence, there was no direct connection between the German measure at issue and the possible loss of revenue. The Netherlands NOx trading scheme case also offers valuable insights on this issue.[21] The question arose as to whether the national cap-and-trade scheme granting free allowances to 250 large facilities entailed the granting of 'state resources' within the meaning of Article 107 TFEU. Emissions reductions, in the form of NOx credits, were offered in the emission market by facilities whose emission fell below the Dutch emission standard.[22] In line with *Preussen Elektra*, the Netherlands considered that there was no direct or indirect transfer of state resources as a result of the distribution of the additional financial burden between the regulated entities.

20 Case C-379/98 *PreussenElektra* [2001] ECR I-2099, paras 54 and 59.

21 Case C-279/08 P *Commission v. Netherlands* [2011] EU:C:2011:551.

22 Case C-279/08 P *Commission v. Netherlands* [2011] EU:C:2011:551, paras. 10–12.

Since the emission standard laid down by the Dutch regulation was a supplementary charge for the entities in question, the purpose of the granting of free allowances was to allow the entities to distribute amongst themselves the additional burdens resulting from that standard.[23]

On first instance, the General Court of the EU held that:

> rather than selling them or putting them up for auction, and by setting up a scheme making it possible to trade those allowances on the market, even if they are linked to a maximum ceiling, the Kingdom of the Netherlands conferred on those allowances the character of intangible assets and has therefore foregone the collection of State resources.[24]

On appeal, the CJEU concurred with the reasoning, and held that:

> an advantage granted by the national legislature, that is, the tradability of NO_x emission allowances, could entail an additional burden for the public authorities in the form of an exemption from the obligation to pay fines or other pecuniary penalties [...]. By establishing the 'dynamic cap' scheme, the Kingdom of the Netherlands gave to the undertakings covered by the measure in question the possibility of buying emission allowances in order to avoid the payment of fines. In addition, the consequence of that system is the creation, without real consideration supplied to the State, of emission allowances which, because of their tradable character, have an economic value. It must be concluded that the Member State could have sold such rights, or where appropriate put them up for auction, if it had structured that scheme differently.[25]

As a result, this case was distinguishable from the *Preussen Elektra* case. It follows that a cap-and-trade scheme offering free of charge the possibility for entities covered by it to trade in emission allowances in order to avoid the payment of fines[26] and conferring on these allowances the character of tradable intangible assets confers an advantage granted through state resources.[27] In effect, the state could have sold such allowances or put them up for an auction.[28]

23 Ibid., para. 97.
24 Case T-233/04 *Netherlands v. Commission* [2008] ECR II-591, paras. 75 to 77.
25 Ibid., para. 106.
26 Directive 2003/87, Article 16.
27 Case C-279/08 P *Commission v. Netherlands* [2011] EU:C:2011:551, para. 106.
28 Opinion of A.-G. Mengozzi in Case C-279/08 P *Commission v. Netherlands*, above, para. 87.

It is settled case law that the advantages granted to entities entailing 'an additional burden for the public authorities in the form of an exemption from the obligation to pay fines or other pecuniary penalties' fall within the ambit of TFEU Article 107.[29] Thus, there is a transfer of state resources in the form of loss of state resources.

Similarly, the fact that a member state does not take advantage of the possibility granted to it to auction off greenhouse gas emission allowances is attributable to the state and financed from the public purse.[30] On the other hand, where allowances are sold to entities at market price, there is no transfer of state resources.

3.1.3 Third Condition: Selectivity

State measures will not amount to state aid within the meaning of Article 107 if they are not selective. In order for a state measure to be considered equivalent to state aid, it is necessary for it to favour 'certain undertakings or the production of certain goods', rather than indiscriminately benefit all relevant entities situated in the member state. This criterion reflects the thinking that the more an aid measure is selective, the more likely it is that it will distort competition.

Selective state aid stands in opposition to so-called general measures of economic policy that are aimed not at favouring specific products or sectors but at all regulated entities in the national territory without distinction. These general measures do not constitute state aid[31] provided that they are justified by the nature of the general structure of the system under which they fall. This would not be the case with a free allocation of allowances, because the criterion of selectivity is fulfilled where the administration called upon to apply arrangements of a general nature uses its discretionary power with regard to the application of the regulatory measure, and where this discretionary power has the effect of favouring certain entities or the production of certain goods.[32] The ETS Directive does not oblige the state authorities to allocate allowances freely to any specific industrial sectors.

29 Case C-295/97 *Piaggio* [1999] ECR I-3735, para. 42.

30 S. Kingston, *Greening EU Competition*, above, 388–92.

31 Case C-143/99 *Adria-Wien Pipeline* [2001] ECR I-8365, para. 35; and Case T-55/99 *CETM v. Commission* [2000] ECR II-3207, para. 40.

32 Joined Cases T-92/00 & T-103/00 *Diputación Foral de Álava ea v. Commission* [2002] ECR II-1385, paras 23, 31, and 35.

3.1.4 Fourth Condition: Negative Impact on Trade between Member States

Finally, for the state measure at issue to be considered state aid, it must be liable to affect trade between member states. It is necessary to establish that the benefit has a negative impact on competition as well as on the free movement of goods. Clearly, these two conditions are inextricably linked. The Commission tends to regard the first condition as having been fulfilled automatically in such cases.[33] In its 2014 guidelines (see below), the Commission stresses that grandfathering or sales by state authorities of allowances below market price may result in significant distortions of competition in the internal market, in particular whenever entities in the same sector are treated differently in different member states due to different budgetary constraints.[34]

3.2 *Exemptions Provided for under Secondary Law*

3.2.1 Introduction

In principle, the prohibition of state aid is neither absolute nor unconditional and is subject to numerous exceptions. For instance, on the basis of TFEU Article 107(3)(c), the Commission may consider compatible with the internal market state aid to facilitate the development of certain economic activities within the EU, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

Since the 1970s, the Commission has been aware that it will not be able to eliminate state aid related to the environmental policy entirely. Against this background, the absence from Treaty law of express exceptions for environmental protection and energy-sustainability measures has not prevented the emergence of an administrative praxis favourable to granting these types of aid on the basis of TFEU Article 107.[35] Resolutely pragmatic, the Commission has delineated the scope of the exceptions through a succession of guidelines, the object of which is to simplify the task of member states wishing to provide assistance to regulated entities. A reduction in the administrative burden of the Commission is the essential utility of these arrangements.

The 2014 guidelines on state aid for environmental protection and energy (replacing the 2008 guidelines[36]) set out the conditions under which aid for

33 P. Thieffry, *Droit de l'environnement*, above, 973.

34 Para. 5 of the Guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012, *OJ C 158, 5.6.2012*, pp. 4–22.

35 Regarding the Treaty bases of these exemptions, see N. de Sadeleer, *EU Environmental Law and the Internal Market* (Oxford University Press, 2014), 453–6.

36 Community Guidelines on State aid for environmental protection *OJ* C 82, 1.4.2008, 1.

energy and environment may be considered compatible with the internal market under TFEU Article 107(3)(c).[37] These guidelines will be in force until the end of 2020.

3.2.2 Arrangements for Climate Change and Energy Sustainability Projects

Among the fourteen categories of aid measures covered by the 2014 guidelines, several are related to energy as well as climate change adaptation and mitigation measures:

- aid for energy-efficiency measures, including cogeneration and district heating and cooling (f);
- aid for CO_2 capture, transport, and storage including individual elements of the Carbon Capture and Storage (CCS) chain (h);
- aid in the form of reductions in funding support for electricity from renewable sources (j);
- aid for energy infrastructure (k);
- aid in the form of tradable permits (m).

The guidelines specify a number of notification thresholds. By way of illustration, aid for energy infrastructure and for CCS must exceed €50 million per investment project to be subject to the notification obligation. Aid for the production of biofuel is subject to the notification obligation where the aid is granted to a biofuel production installation at sites where the resulting production exceeds 150,000 tonnes per year.[38] No threshold is stated for the free allocation or the selling below market value of emission allowances.

Whenever the guideline's thresholds are exceeded, state aid for environmental protection and energy objectives will be considered compatible with the internal market within the meaning of TFEU Article 107(3)(c) insofar as, on the basis of the common assessment principles set out in the guidelines, it is consistent with a set of principles, namely consistent with an objective of common interest, necessity, appropriateness, incentivizing effect, proportionality, and transparency.[39] Stemming from general principles of EU administrative law,[40] these principles strike a balance between 'an increased contribution to the Union environmental or energy objectives' and competition between entities within the internal market.[41]

37 *OJ C 200, 28.6.2014*, pp. 1–55.
38 2014 guidelines, para. 20.
39 Ibid., para. 27.
40 P. Craig, *EU Administrative Law*, 3rd ed. (Oxford University Press, 2018) 388–699.
41 2014 guidelines, para. 23.

It should be noted that individual aid granted which is covered by the guidelines remains subject to the notification obligation pursuant to TFEU Article 108(3), irrespective of whether it complies with the conditions specified under the guidelines. It is likely that the Commission will view favourably any proposed aid that fulfils these criteria. In addition, member states will find useful indications in the guidelines on the criteria that the Commission will apply when examining a case of aid.

As a result, national authorities have to assess whether their aid measures aiming to improve the quality of the environment and energy sustainability are likely to be justified under one of the heads of the 2014 guidelines. In order to ensure transparency and legal certainty, the Commission has explained the compatibility criteria to be applied to these state-aid measures.[42] The aid at issue must be necessary to achieve the environmental objective of the EU ETS (necessity of the aid) and must be limited to the minimum needed to achieve the environmental protection sought (proportionality of the aid) without creating undue distortions of competition and trade in the internal market.[43]

As discussed below, fulfilment of the incentivizing effect and achievement of a higher level of environmental protection are likely to put the proposed aid in a good light.

Incentivizing effect. Recommendation 75/463 on cost allocation and action by public authorities on environmental matters stresses that the PPP should demonstrate a preventive dimension. Put at the service of prevention, the PPP should not be interpreted as allowing a polluter who pays to continue polluting with impunity. The true aim of the principle would be to institute a policy of pollution abatement by encouraging polluters to reduce their emissions instead of being content with contributing financially to the administrative pollution-control costs. To the extent that charges imposed on the polluters increase in proportion to the significance of their pollution, it will be in their interest to reduce their emissions.

As far as secondary energy law is concerned, the incentivizing function may be illustrated by the 'indirect taxes on excise goods for specific national purposes' adopted by member states in virtue of the general arrangements under Directive 92/12/EEC.[44] The CJEU has had to determine the conditions under which state authorities could adopt indirect taxes on hydrocarbons subject to

42 Guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012, *OJ C 158, 5.6.2012*, pp. 4–22.

43 2014 guidelines, para. 5.

44 Council Directive 92/12/EEC of 25 February 1992 on the general arrangements for products subject to excise duty and on the holding, movement and monitoring of such products, Article 1(2).

the EU's excise-duties regime. In *Transportes Jordi Besora*, the Court dismissed the argument that the allocation of tax revenue for environmental purposes was sufficient to prove that the tax was aiming at an objective 'other than a purely budgetary objective'. In stressing that the tax must be designed 'in such a way as to dissuade taxpayers from using mineral oils or to encourage the use of other products that are less harmful to the environment', the Court emphasized its incentivizing function.[45] By the same token, regarding an Estonian sales tax on liquid fuel, the Court emphasized that the tax should have been 'designed … in such a way as to deter taxpayers from using this fuel or to encourage them to adopt a behaviour whose impact would be less damaging to the environment or public health than that which they would adopt in the absence of the tax'.[46]

Against this background, the 2014 guidelines allow environmental and energy aid, inasmuch as they have an incentivizing effect.[47] According to the guidelines, an incentivizing effect occurs

> when the aid induces the beneficiary to change its behaviour to increase the level of environmental protection or to improve the functioning of a secure, affordable and sustainable energy market, a change in behaviour which it would not undertake without the aid. The aid must not subsidise the costs of an activity that an undertaking would anyhow incur and must not compensate for the normal business risk of an economic activity.[48]

The Commission considers that aid granted to adapt to forthcoming Union standards in principle has an incentivizing effect, including when the standard has already been adopted but is not yet in force.[49] The incentivizing effect would be lacking where the investment concerned would have been made without the aid.

Higher level of environmental protection. Companies have no incentive to go beyond binding environmental standards whenever the costs exceed their economic benefits. The level of protection afforded by EU secondary law is far from being optimal. The vast majority of EU texts are the result of uncanny compromises.[50] As a result, member states have to be encouraged to go

45 Case C-82/12 *Transportes Jordi Besora* [2014] C:2014:108, para. 32.
46 Case C-553/13 *Tallinna Ettevõtlusamet* [2015] C:2015:149, para. 46.
47 2014 guidelines, para. 49.
48 Ibid.
49 2014 guidelines, para. 53.
50 N. de Sadeleer, *EU Environmental Law*, above, 216–17.

beyond the EU-harmonized standards whenever more stringent domestic standards do not hinder the functioning of the internal market. Against this backdrop, the Commission accepts state aid that is capable of being justified by the need to apply more stringent environmental protection standards or energy objectives than those provided for under EU law or, where no standards have been adopted by the Union, that are likely to increase the level of protection resulting from the activities of the beneficiary.[51] Accordingly, they cannot guarantee activities whose economic viability offers cause for concern. This means that the aid cannot cover investment designed to permit entities to deal with the costs resulting from bringing their operations into line with existing EU environmental provisions.

This regulatory approach is consistent with Article 3(3) of the Treaty of the EU, TFEU Article 191(2), and Article 37 of the Charter of the Fundamental Rights of the EU,[52] according to which EU policies are to aim to attain a high level of environmental protection. By virtue of these provisions, EU institutions are expected to adopt more of an interventionist than conservative stance,[53] meaning that they are not only required to avoid degradation of the environment but must also seek to improve its quality.

3.2.3 Criteria Applicable to State Aid Granted to Climate Change and Sustainable-energy Projects

A complete analysis of all the categories of projects covered by the 2014 guidelines is impossible in the space available here. The focus will be on the EU ETS. The guidelines first recall that the granting of allowances by national authorities may involve state aid in a number of instances, in particular when allowances are granted for less than their market value.[54] Tradable-permit schemes are considered to be compatible with the internal market if the following cumulative conditions are met:[55]

> (a) the tradable-permit schemes must be set up in such a way as to achieve environmental objectives beyond those intended to be achieved on the basis of Union standards that are mandatory for the entities concerned;

51 2014 guidelines, para. 55.

52 With respect to measures related to the establishment and the functioning of the internal market, TFEU Article 114(3) lays down a similar obligation.

53 N. de Sadeleer, *EU Environmental Law*, above, 45–56.

54 2014 Guidelines, para. 247.

55 Ibid., para. 235.

(b) the allocation must be carried out in a transparent way, based on objective criteria and on data sources of the highest quality available, and the total amount of tradable permits or allowances granted to each beneficiary for a price below market value must not be higher than its expected needs in a situation without the trading scheme;
(c) the allocation methodology must not favour certain entities or certain sectors unless this is justified by the environmental logic of the scheme itself or where such rules are necessary for consistency with other environmental policies;
(d) new entrants are not in principle to receive permits or allowances on more favourable conditions than existing entities operating in the same markets. Granting higher allocations to existing installations compared to new entrants should not result in creating undue barriers.

The guidelinevs set forth the criteria that must be applied in the assessment of the necessity and the proportionality of state aid involved in a tradable-permit scheme.[56] In order to enhance the competition, the choice of aid beneficiaries must be based on objective and transparent criteria, such as that a substantial increase in their production costs cannot be passed on to customers without leading to significant sales reductions.[57]

4 The PPP and EU State-aid Law

Although the aid granted to recipient installations aims to avoid an increase in global greenhouse gas emissions by a shift in production outside the Union, it may have a negative impact on the efficiency of the EU ETS. According to the Commission, 'if poorly targeted, the aid would relieve the beneficiaries of the cost of their indirect emissions, thereby limiting incentives for emission reductions and innovation in the sector'.[58] As a result, the costs of reducing emissions would have to be borne mainly by other sectors of the economy. Therefore, state aid runs counter not only to competition law but also to the PPP. In fact, thanks to the granting of aid to cover investments to abate greenhouse gas

56 Ibid., para. 236.
57 Ibid., para. 236(c).
58 Commission Guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012 (SWD(2012) 130 final).

emissions, the beneficiary will not incorporate into its costs the externalities relating to environmental degradation but will transfer responsibility for these onto society. As a result, the polluter is relieved of the burden of paying the costs of its own pollution. The TFEU provides no guidance for resolving this paradox. The ETS Directive does not make any reference to the PPP.

4.1 *Status of the PPP in EU Law*

The PPP is deemed to be one of the pillars of the EU's environmental policy. In falling into step with the recommendations adopted by the OECD Council in the course of the 1970s,[59] the European Commission has attempted to clarify the principle in a series of recommendations and resolutions, subsequently granting it legal effect. The procedures for applying the PPP were specified in Recommendation 75/436/Euratom, ECSC, EEC, of 3 March 1975 (hereinafter Recommendation 75/436), regarding cost allocation and action by public authorities on environmental matters, which broadly takes up the OECD's recommendations.[60] Although Recommendation 75/436 is not binding per se, national courts are obliged to take it into account when resolving conflicts, particularly when it clarifies the interpretation of national provisions intended to implement EU provisions of a binding nature.[61] Several decades later, Recommendation 75/436 remains indispensable for understanding the significance of the PPP.[62]

The legal nature of the PPP has been shifting from soft law to hard law. Since 1987, the principle has been enshrined in TFEU Article 191(2), which states that 'action by the Union relating to the environment shall be based on the principle that the polluter should pay'.[63] Like its companion principles of prevention and precaution, the PPP is meant to guide the definition and implementation of EU environment policy. The Treaty confirms its essential role by recalling in Article 192(5) that the PPP continues to apply even when the legislature uses its power to grant a temporary derogation from implementing domestic measures involving 'costs deemed disproportionate for the public authorities of a Member State'.

59 N. de Sadeleer, *Environmental Principles: From Political Slogans to Legal Rules* (Oxford University Press, 2002), 26–7.

60 See, for instance, the 1972 Council Recommendation on Guiding Principles concerning International Aspects of Environmental Policies (C (72) 128 (final)).

61 Case C-322/88 *Grimaldi* [1989] ECR I-6669, para 32.

62 Regarding the history of the PPP in EU law, see N. de Sadeleer, *Environmental Principles: From Political Slogans to Legal Rules*, 2nd ed. (Oxford University Press, 2020).

63 In contrast to the English version, the other linguistic versions of the TFEU emphasize the binding nature of the PPP.

The EU's institutions are obliged to take the PPP into consideration in the course of normative processes; in this way, all acts of secondary law must be subordinated to the principle.[64] In addition, the CJEU ensures respect for the PPP in the cases it is called upon to decide.[65] The requirement that action by the EU relating to the environment is to aim at fleshing out the PPP does not, however, prevent the EU institutions from exercising a wide degree of discretion in shaping the EU's environmental policy. This is reinforced by the need for the EU institutions to weigh the Article 191(2) principles against each other and against various policy objectives.[66]

The PPP has attracted criticism on the grounds that it contains neo-liberal overtones that appear to countenance the idea that the right to pollute can be purchased for a monetary equivalent of the environmental cost sustained. Consequently, it is seen as accepting environmental degradation as inevitable, provided that the agent pays—'I pay, therefore I pollute'. For the regulated entity, however, a charge represents a supplementary tax, and the result is a perpetuation of pollution for as long as the entity pays for the administrative authorities to carry out their regulatory tasks. Thus the PPP has no dissuasive value, but encourages polluters to pass on their costs to consumers.

4.2 *The PPP and EU State-aid Law*

Since the early 1970s, both the OECD and the EU have justified recourse to the PPP to prohibit state aid from being used to finance anti-pollution investments. The 1972 OECD Recommendation on Guiding Principles Concerning International Economic Aspects of Environmental Policies stated that the principle was to be used 'to avoid distortions in international trade and investment'.[67] In addition, according to the Community Environmental Action Programmes of the 1970s, exceptions to the PPP must 'cause no significant distortion to international trade and investment'.[68] Allowing private enterprises to benefit from public assistance in financing such investments would obviously have run counter to the doctrine of free trade promoted by both economic organizations, since such aid distorts competition between beneficiary firms and their competitors. Consequently, exceptions to this prohibition were

64 L. Krämer, 'The Polluter Pays Principle in Community Law: The Interpretation of Art. 130r of the EEC Treaty', in *Focus on European Law*, 2nd ed. (Graham and Trotman, 1997), 244.

65 Case C-284/95 *Safety Hi-Tech* [1998] ECR1-4301; Case C-341/9 *Bettati* [1998] ECR I-4358; and Case C-293/97 *Standley* [1999] ECR I-2603, paras 51–2.

66 N. de Sadeleer, *Environmental Principles*, above.

67 1972 Council Recommendation on Guiding Principles concerning International Aspects of Environmental Policies, above.

68 N. de Sadeleer, *Environmental Principles*, above, 28–9.

authorized only in exceptional circumstances and on the condition that precise criteria were respected: aid could only be granted for a transitional period, to entities facing serious difficulties, and was not to give rise to serious distortions of commercial trade and international investment. However, the initial desire to eliminate all public aid for environmental matters by recourse to the principle has been tempered by the guidelines relating to state aid for the protection of energy and environment. [69]

The role played by the PPP in the Commission' state-aid practice has been underscored in the *GEMO* case by Advocate General Jacobs:

> In its State aid practice the Commission uses the polluter-pays principle for two distinct purposes, namely (a) to determine whether a measure constitutes State aid within the meaning of [TFEU Article 107(1)(b)] to decide whether a given aid may be declared compatible with the Treaty under [TFEU Article 107(3)].
>
> In the first context, that of [TFEU Article 107(1)], the principle is used as an analytical tool to allocate responsibility according to economic criteria for the costs entailed by the pollution in question. A given measure will constitute State aid where it relieves those liable under the polluter-pays principle from their primary responsibility to bear the costs. In the second context, that of [TFEU Article 107(3)], the polluter-pays principle is used by contrast in a prescriptive way as a policy criterion. It is relied on to argue that the costs of environmental protection should as a matter of sound environmental and State aid policy ultimately be borne by the polluters themselves rather than by States.[70]

The PPP therefore provides a standard for analysis that makes it possible to determine on whom the costs fall, in order to establish whether a given measure constitutes state aid pursuant to TFEU Article 107(1). A state measure that relieves those actors of those costs is thus to be regarded as an economic advantage capable of constituting state aid. The Commission, which is responsible for approving state aid, regularly applies the PPP, refusing to allow state aid that infringes upon TFEU Article 107.[71] As discussed above, the Commission, according to the guidelines, will only accept state aid that is capable of being justified by the need to apply more stringent environmental protection

69 N. de Sadeleer, *EU Environmental Law*, above, 435–67.

70 Opinion of A.-G. Jacobs in Case C-126/01 *GEMO* [2003], paras 68–70.

71 See examples in de Sadeleer, *EU Environmental Law*, above, 435–67.

standards than those provided under EU law or, where no standards have been adopted by the Union, that are likely to increase the level of protection resulting from the activities of the beneficiary. Therefore, the aid must have an incentivizing effect that is consistent with the PPP. The granting of aid is nothing but a 'last resort', 'alternative', or 'second-best option', as the PPP remains the rule.[72]

Finally, although the CJEU has already adjudicated a number of landmark cases regarding the scope of the EU ETS and its consistency with the principle of equal treatment,[73] inclusion of aviation emissions,[74] access to trading data,[75] enforcement,[76] etc., it has not decided any major case on the state-aid issue related to the EU ETS.

5 Conclusion

The transitional allocation of free allowances in the electricity sector, as well as the granting of allowances for free or below their market price in general, are caught by TFEU Article 107(1). Such measures confer an advantage to the recipient installations. By choosing not to auction allowances, the state deprives itself of a resource. The fact that this advantage funded by state resources is conferred exclusively on certain economic sectors makes the measure selective. Such measures are likely to affect trade between member states and distort competition. They seem contrary to the PPP on account that they subsidize emissions of greenhouse gases instead of internalizing them into the price of goods and services provided by the beneficiary installations.

The PPP easily wins approval and has an important role to play in furthering environmental and climate change law at the EU level. However, the principle's outlines remain singularly difficult to trace in state-aid law, despite the simplicity of its message. Auctioning allowances is the most appropriate means of implementing a cap-and-trade scheme in accordance with the PPP. In order to be consistent with that principle, state aid must not only correct market failures but also have an incentivizing effect and be limited to what is necessary to achieve a higher level of ambition than the one required by EU

72 Ibid., 461–63.

73 Case C-137/07 *Arcelor Atlantique* [2013] ECLI:EU:C:2013:664 [2008] ECLI:EU:C:2008:728.

74 Case C-366/10 *Air Transport Association of America and Others v. Secretary of State for Energy and Climate Change* [2011] ECLI:EU:C:2011:864.

75 Case C-524/09 *Ville de Lyon v Caisse des dépôts et consignations* [2010] ECLI:EU:C:2010:822.

76 Case C-203/12 *Billerud Karlsborg AB and Billerud Skärblacka AB v Naturvårdsverket* [2013] ECLI:EU:C:2013:664.

standards. Prioritizing an environmentally principled approach, the Commission's guidelines offer important guidance in this connection.

Micro-management of all low-carbon-support measures is likely to overburden the Commission and increase the risk of non-achievement of decarbonization goals. For this reason, in its Communication on state-aid modernization, the Commission announced that, included among the objectives pursued on the modernization of state-aid control, it would enhance the decision-making process and focus ex-ante scrutiny on cases having the biggest impact on the functioning of the internal market.[77]

77 COM(2012) 209 of 8.5.2012.