

AUCTIONS – THE SOLUTION TO WINDFALL PROFITS AND END OF ALL STATE AID PROBLEMS?

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Introduction

On 25 October 2003 the Directive 2003/87/EC (later referred to as the ‘Directive’) governing the European Emissions Trading System (EU ETS) for greenhouse gas emission allowances for energy intensive installations entered into force. The greenhouse gas emissions trading system started with the operation of the first trading phase in January 2005. Around 5000 operators with approximately 12.000 installations participate in this multi-jurisdictional attempt to reduce CO₂ emissions from four broad sectors: energy (electric power, oil refineries, etc.), the production and processing of ferrous metals (iron and steel), minerals (cement, glass, ceramics), pulp and paper. The program is implemented in multiple phases: the first ranging from 2005 – 2007 and the second from 2008 – 2012, which resembles the Kyoto Protocol compliance period. The following periods were, according to the Directive, 5 years long, but the third trading period is extended under the amendment of the Directive till 2020. While the second trading phase (2008 – 2012) was subject to increased Commission scrutiny and saw a strong reduction of the number of emission allowances that were distributed, it has not seen fundamental legal changes. Drastic amendments to the legal framework championing auctioning as the ultimate mechanism of allocation for the third trading phase (2013 – 2020) have been adopted in 2009 and the EU ETS Directive was amended by Directive 2009/29/EC.

This article reviews two issues that were much criticised with regard to the so-called ‘grandfathering’ allocation method that describes the allocation of emission allowances for free on the basis of historical emission records. By increasing auctioning under the amended Directive, both windfall profits and State aid concerns are presumably problems of the past. Before elaborating upon both issues, I will briefly describe what the underlying problems are. ‘Windfall profits’ is a term commonly used to describe a ‘free lunch’. In the framework of the EU ETS it describes a situation wherein emitters receive emission allowances for free or at beneficial terms while still passing on costs to consumers. There has been much public dismay about this practice that is widely felt to be ‘unfair’. Auctioning has been introduced on a large scale, also to address such windfall profits. I will argue below that auctions will only mitigate but not eradicate the perceived ‘unfairness’ and submit that we actually should not be concerned about windfall profits in the first place.

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A second issue related to allocation of allowances is the question of whether the rules regarding State aid (Article 107 TFEU (ex Article 87 EC Treaty)) have been observed. Put simply, State aid rules prevent Member States from granting undertakings (legislative term used to denote a concept that is broader than ‘enterprise’) undue advantages over their competitors. While State aid rules have been an important consideration in the context of grandfathering, auctions are expected to solve this issue too. In the view of auction theorists, auctions are realising their superior allocative properties if they are addressing the preferences of bidders appropriately. This in turn suggests that tailor-made auctioning systems may be desirable for the large number of participants in the EU ETS. In such a framework, however, auctioning rules may lead to differences in prices and thus to an unequal distribution of benefits among undertakings. The European Commission’s tendency to presuppose that there is no State aid involved in competitive processes should thus be questioned. I will argue below that advantages can still accrue to undertakings participating in auctions and that they should be examined from a State aid perspective. I will do so by giving an actual example from the second trading period to elucidate my point.

I. Windfall Profits

In the current trading phase of the EU ETS an auction was held on 19 November 2008 in the United Kingdom. Approximately 4 million allowances were sold at a clearing price of €16.15 (£13.60) per allowance. The auction was more than four times oversubscribed and organised with the support of large corporations that acted as primary participants (such as Barclays Capital, BNP Paribas, JP Morgan and Morgan Stanley). On the one hand, this competitive auction generated a positive price, raised millions of Euros, and could thus be described as an overwhelming success. On the other hand, the spot market price of allowances on the same day at the Leipzig Energy Exchange (one of the trading forums for allowances) was €16.42 per allowance, while some suggest that the market value of an allowance at the time of closing the auctions was as high as €16.60 per allowance. In light of these figures, the auction may have caused dismay to the Chancellor of the Exchequer who was basically selling emission allowances for 1 – 1.8 million Euros below their market value.

Undertakings participating in this competitive auction have thus been attaining a benefit to the extent that the difference between the auction clearing price and the spot market price does not reflect their increased transaction costs from preparing for the auction. It illustrates that the price on auctioning markets can and will lie below prices prevailing on the secondary market. After all, why should bidders pay more if they can get allowances cheaper? As participants in the secondary market become more familiar with the auctions and face lower transaction costs, the prices on both markets should approximate each other in the long run. How long the price

difference between the auction market and the secondary market remains will of course also depend upon the complexity and variety of the auction designs. The wording contained in the Directive does not disclose how many auction designs will be permissible on EU level, but a draft outline of the auctioning regulation points in the direction of a single auction format. Auctions develop their superior allocation effects in particular in the context of tailor-made solutions to the bidders, and not in a 'one size fits all approach'. However, it is not yet entirely clear how the Commission will address such choices. Nevertheless, this example shows that with auctions, there are also 'benefits to be reaped' (though they are much smaller).

Windfall profits may thus still arise to the extent that undertakings buy allowances at a discount. Since allowances constitute a factor of production, it is rational behavior to price the costs in at the respective market price and pass them on, to the extent possible, to consumers. Whether it is profitable for a company to do this, will depend on the particular elasticities (an economic measure indicating how for example demand changes if price increases). If the market is such that it is profitable to pass on higher costs to consumers, windfall profits could still occur.

Windfall Profits – should we be concerned?

Should we be concerned about windfall profits? Not really. As in other settings (levying taxes or business negotiations) the costs tend to fall more heavily on the side that can least avoid them. There may thus still be consumers that perceive such examples as 'unfair', but they are a normal element of our market-oriented economy. Auction theory, particularly if organised on a large scale in such a way that the price differential between the primary and secondary market disappears, can do a great deal in mitigating the 'unfairness', but the amended Directive may not succeed in eradicating it.

II. State Aid

A second issue related to potential benefits to undertakings participating in an auction is State aid. As indicated above, there is the possibility that a benefit accrues to undertakings participating in an auction. We should not presuppose that competitive auctions do not give rise to any State aid concern, but invite the Commission to closely monitor what is happening in auction contexts. While I have examined the relationship between auctions and State aid in more detail elsewhere¹, I would like to briefly comment upon one particularly interesting aspect in the State aid assessment: that aid must be imputable to the State.

¹ See S. Weisbaaer, Towards auctioning: the Transformation of the European Greenhouse Gas Emission Trading System – Present and future challenges to Competition law, *The Hague, Kluwer Law International 2009*, pp. 272.

Pursuant to the EU ETS amendment Member States are obliged to auction all allowances that are not allocated for free. Member States will also have to observe the Commission Regulation on timing, administration and other aspects of auctioning (to be adopted by 30 June 2010) that seeks to ensure that auctions are conducted in an open, transparent, harmonised and non-discriminatory manner. To the extent that Member States merely implement legislation, there is no imputability and hence no State aid. However, it is not yet known how these rules will be designed and what discretion will be left to the Member States. In contrast to its recent proposal, it could for example be possible that the European Commission designs two or three auction systems from which Member States can choose – after all, auctions perform best if they are tailored to the bidder preferences. It also bears mentioning that some Member States (notably the Netherlands) have already expressed that they see auctioning as an allocation mechanism and not as a means to raise revenues – something that auction systems are frequently designed to achieve.

In such a context it could for example be entirely possible that a Member State selects an auctioning mechanism that is *not* designed to produce high revenues rather than an auctioning mechanism that does produce high revenues. The discretion granted to the Member State to select the less profitable auctioning mechanism would imply that Member States would be willfully forgoing revenue. Since Member States are only under a duty to auction those allowances not allocated for free, their decision to do so in a less profitable way constitutes an act that is at their own discretion. Member States are thus bound by their obligation to respect the TFEU, including Article 107(1). In such situations it may well be questioned if advantages accruing to undertakings as a consequence of Member State choices are not imputable to Member States within the meaning of Article 107(1) TFEU. In light of the CFI's and the Commission's decision on the Dutch NOx system, failure to generate profits at a time when Member States have discretion to do so should lead to the establishment of State aid.

Conclusion

In light of the above discussion, I think that auctions offer good opportunities for allocating emission allowances, but they require due consideration. They are by no means the trivial and problem-free solution to the challenge of allocating allowances that some may assume. The perceived 'unfairness' that lies at the bottom of the windfall profits discussion will not be eradicated by the current legal design. It may only be overcome by further increasing the importance of auctioning to such an extent that the secondary market price becomes less important. In addition one may question the relevance of the discussion on windfall profits in the first place since it is a ubiquitous and largely accepted phenomenon of our market-oriented economy.

The Commission's interest that was recently expressed in its draft outline of the auctioning regulation points in the direction of a single auction format and may thereby limit the expected benefits from tailor-made auctioning designs. If, however, several auction mechanisms would be allowed and Member States would have discretion to select auction systems or to hold auctions at points in time in which undertakings could be favored, State aid issues are a concern. The Commission's tendency to presuppose that State aid is not a concern in the context of competitive biddings should be scrutinised.

