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MANNHEIMER SWARTLING



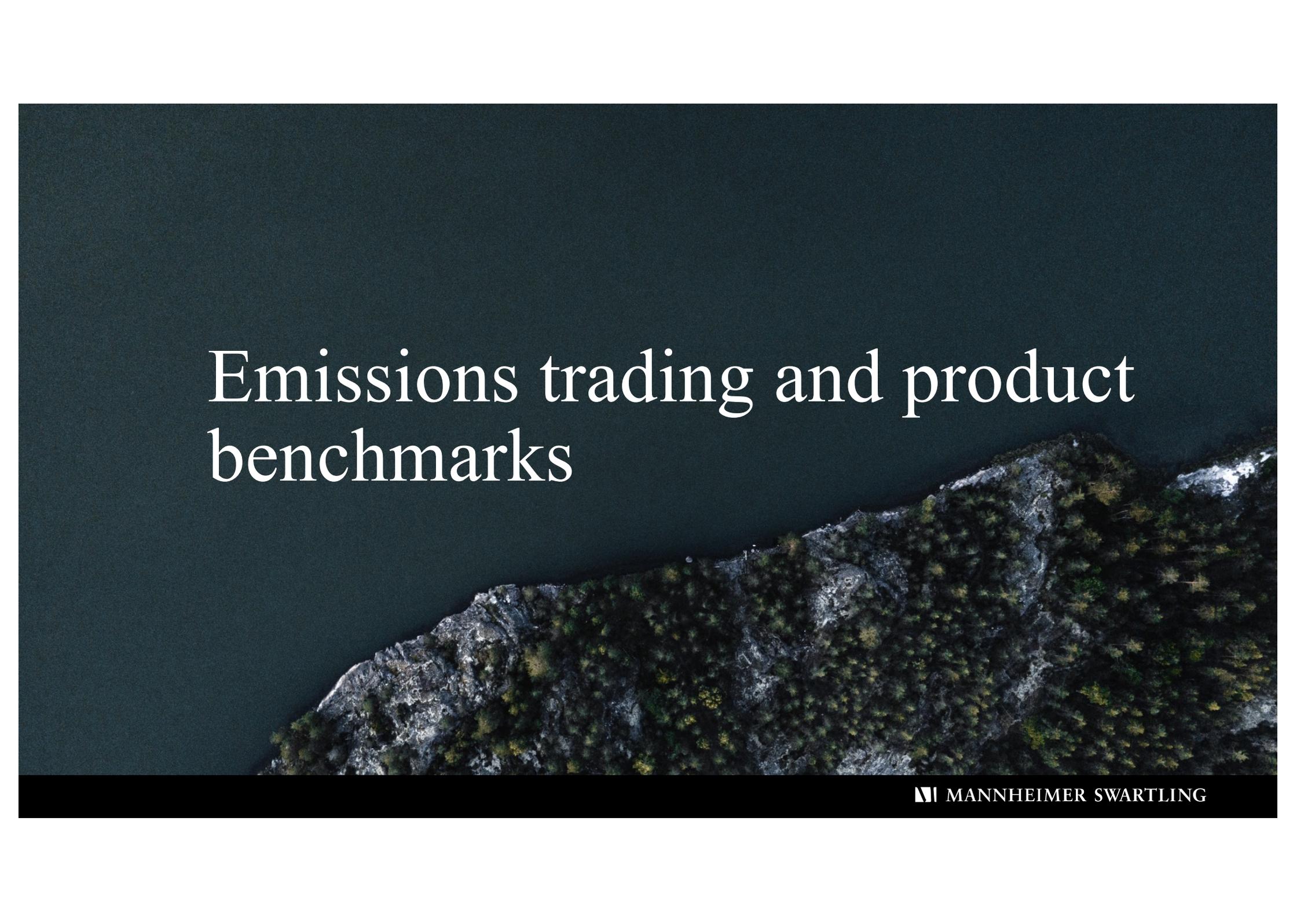
Product benchmarks – the role of substitutes in achieving the objectives of the EU ETS

22 November 2022

Today's presentation

- Emissions trading and product benchmarks
- The *LKAB* case
- Future outlook





Emissions trading and product benchmarks

The logic of emissions trading

- Creates a cost for CO2 emissions to incentivise reductions (“polluter pays”)
- Establishes a market to ensure efficient allocation of emissions through auctioning
- Ensures equal treatment to avoid distortions of competition



The "necessary evil": Free allowances

L. Hermwille,
& C. Arens (2016)
*transformative
emissions trading
Management*,
Issue 5-6

Yet the promise to provide free allocations was key to gain industry support to agree on the EU ETS in the first place, as it is

teau (2005), cited in 30]. In fact, it may well be the case that free allocation mechanisms are a "necessary evil" to be able to establish an ETS.

- EU "subsidy" of €200 billion since 2008.
- Estim. €400 billion over the next ten years
- Applicable until at least 2031

Free allowances; from grandfathering (2005) to product benchmarks (2013)

During phases 1 and 2, most allowances in all Member States were given out for free based on

The benchmarks are very important for the transition towards a low-carbon economy. They provide a strong signal for what is possible in terms of low-carbon production.

installations. Benchmarking allocates allowances based on their production performance instead of

Being set at this level, the benchmarks may represent a challenge for some installations at the beginning and necessitate a transition to significantly more greenhouse gas- and fuel-efficient production. The main reason for potential significant differences in certain

product = one benchmark' as mandated by the ETS Directive). As the benchmarks are an implementation of the requirements of the ETS Directive, the room for Commission's discretion is strictly limited by these rules. The issue of fuel- or technology- specific allocation has been carefully analysed by the Commission's legal service, which has concluded that is not in line with the Directive.

¹ Directive 2003/87/EC, revised by Directive 2009/29/EC.

The Court's view on the "substitutes" criterion in benchmark-setting

C-80/16, para. 47

Art. 10a (1) ETS Directive

47 Had the Commission failed to take into account the installation producing a sintered ore substitute it would have adopted a decision contrary to the purpose of Article 10a(1) of Directive 2003/87,

for reductions in greenhouse gas emissions and energy efficient techniques, by taking account of the most efficient techniques, substitutes, alternative production processes, high efficiency cogeneration, efficient

REG. Mtd. at 11. Arc v. Minu. comp. C.G. I. Advoc. Registrar V. Giacobbo-Peyronnel, Administrator, having regard to the written procedure and further to the hearing on 26 January 2017, after considering the observations submitted on behalf of:

- ArcelorMittal Atlantique et Lorraine SASU, by J. Herschel, avocate,
- the French Government, by D. Colas, T. Deleul and J. Traband, acting as Agents,
- the German Government, by T. Henze, acting as Agent,
- the Swedish Government, by A. Falk, acting as Agent,
- the European Commission, by E. White and K. Mifsud-Bonnici and by O. Beynet, acting as Agents,

1 Language of the case: French.

EN ECLEU:C:2017:588 1

25.10.2003 INCL.

The measures referred to in the first subparagraph shall be the extent

Member States have agreed to reduce anthropogenic greenhouse gas emissions in accordance with the commitments they have entered into under the Kyoto Protocol and to Member States more efficient European market in greenhouse gas emissions, with the least possible development and employment.

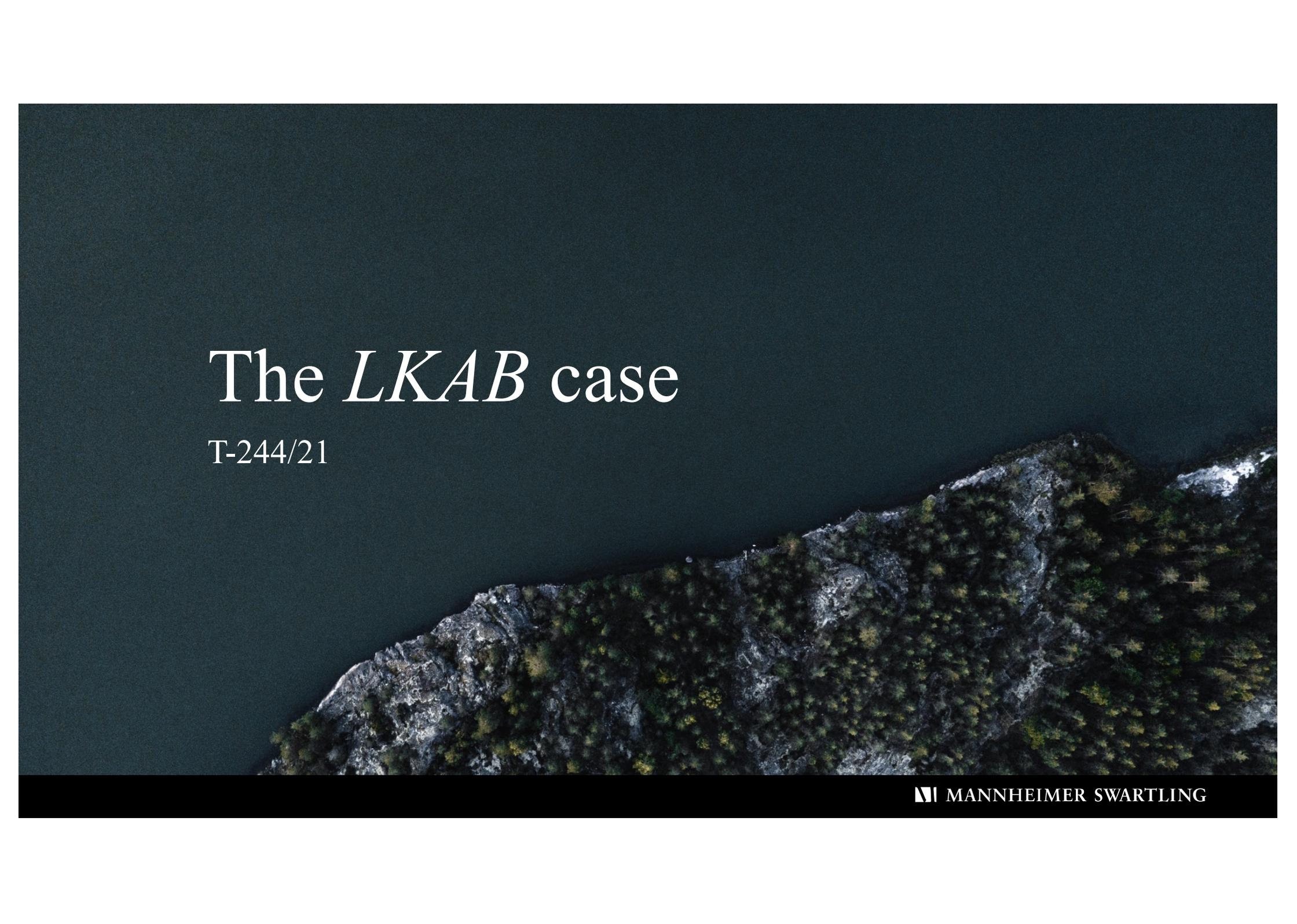
66 Council Decision 93/389/EEC of 24 June 1993 for a monitoring mechanism of Community CO₂ and other greenhouse gas emissions (7), established a mechanism for monitoring greenhouse gas emissions and evaluating progress towards meeting commitments in respect of these emissions. This mechanism will assist Member States in determining the total quantity of allowances to allocate.

7) Community provisions relating to allocation of allowances by the Member States are necessary to contribute to preserving the integrity of the internal market and to avoid distortions of competition.

(2) The Sixth Community Environment Action Programme established by Decision No 1600/2002/EC of the European Parliament and of the Council (7) identifies climate change as a priority for action and provides for the establishment of a Community-wide emissions trading scheme by 2005. That Programme recognises that the Community is committed to achieving an 8% reduction in emissions of greenhouse gases by 2008 to 2012 compared to 1990 levels, and that, in the longer-term, global emissions of greenhouse gases will need to be reduced by approximately 70% compared to 1990 levels.

(7) OJ C 73 E, 26.3.2002, p. 33.
 (8) OJ C 211, 17.9.2002, p. 27.
 (9) OJ C 192, 12.8.2002, p. 59.
 (10) Opinion of the European Parliament of 10 October 2002 (not yet published in the Official Journal), Council Common Position of 18 March 2003 (OJ C 125 E, 27.5.2003, p. 72), Decision of the European Parliament of 2 July 2003 (not yet published in the Official Journal) and Council Decision of 22 July 2003.
 (11) OJ L 242, 10.9.2002, p. 1.

(7) OJ L 31, 7.3.1994, p. 11.
 (8) OJ L 130, 15.5.2002, p. 1.
 (9) OJ L 187, 9.7.1993, p. 31. Decision as amended by Decision 1999/298/EC (OJ L 117, 5.5.1999, p. 35).



The *LKAB* case

T-244/21

The *LKAB* case in a nutshell:
Are these products substitutes?



Facts of the case

- Same raw material (iron ore)
- Used interchangeably
- Almost identical production processes, but enormous difference in climate performance: **29–57 kg** CO₂ per tonne sintered pellets vs **265 kg** CO₂ per tonne sintered fines = 80-90 % reduction
- Including pellets would reduce benchmark value significantly and result in a reduced total number of free allowances
- The Commission is arguably bound by the substitutability criterion in Article 10a ETS directive in both benchmark setting and application

→ ETS is supposed to create – not remove – incentives for transition

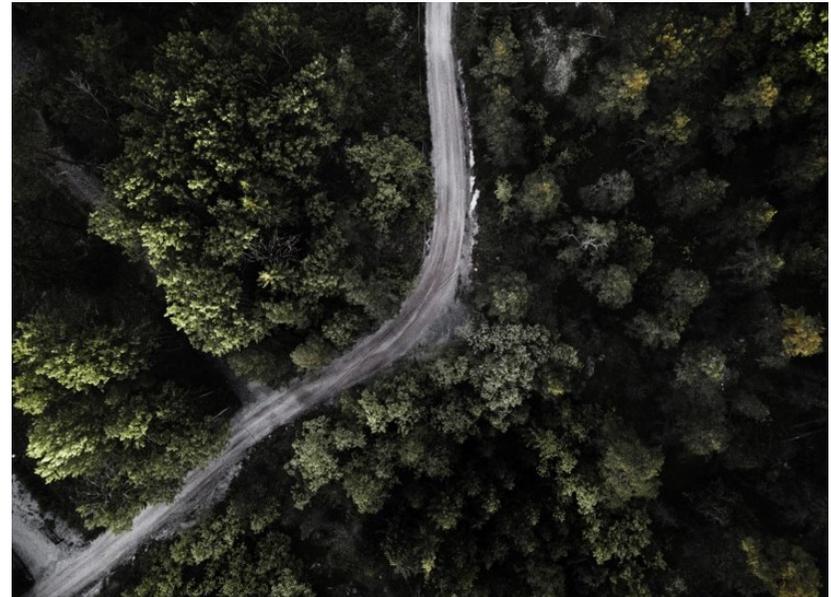
Broader implications of the court case

- For the steel sector: impacts incentives for use of pellets or fines; considerable climate impact in its own right
- Potential precedents for the broader benchmark system:
 - The court's standard of review and the EC's margin of discretion
 - Narrow versus broad concept of substitutability – a broader concept of substitutability improves environmental outcomes
 - The binding nature of the substitutability criterion
 - Would support bolder, principled EU climate action

Future outlook

Lessons learned

- No free allocation would provide the strongest incentives for large-scale transition, but does not address the risk of carbon leakage
- If free allocation is necessary, low- and zero-carbon technologies *must* receive free allowances on same terms as legacy technologies
- Efficient incentives for transition requires broad product benchmarks. Disruptive business impact must be cushioned in other ways than separate benchmarks.
- Need for transparency in benchmark-setting



The future of the product benchmarks

- Current benchmarks will be reviewed before 2026-2030 trading period, under revised wording in the ETS Directive
- Judgment of the GC in T-244/21 expected during 2023
- CBAM will phase out free allocation in covered sectors by 2032 / 2035



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