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The Allocation of Free Emissions Allowances by Germany to its Steel Industry: A Possible Subsidy Claim Under the W.T.O. Agreement on Subsidies and Countervailing Measures

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COMMENT

THE ALLOCATION OF FREE EMISSIONS ALLOWANCES BY GERMANY TO ITS STEEL INDUSTRY: A POSSIBLE SUBSIDY CLAIM UNDER THE W.T.O. AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES

VIDHI R. SHAH^{*}

The European Union Emissions Trading Scheme (“E.U. Scheme”) is the largest and most ambitious carbon dioxide emissions trading system in the world. However, Directive 2003/87/EC, which establishes the E.U. Scheme, gives the Member States of the European Union too much discretion to devise individual National Allocation Plans (“NAPs”). Germany’s NAP allows for the allocation of free emissions allowances. This methodology is inconsistent with the World Trade Organization’s Agreement on Subsidies and Countervailing Measures. This comment proposes two amendments to the Directive, namely the requirement of a minimum level of scarcity on the amount of emissions allowances in NAPs and the development of strict guidelines on the methods of distributions employed in those NAPs. These amendments would have key effects on subsequent phases of the E.U. Scheme. Specifically, they would

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prevent Member States from bringing subsidy claims in the future and would ensure that the scheme operates at the most efficient and cost-effective level.

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I. INTRODUCTION

“Climate change is the greatest environmental risk facing the world today.”¹ The warmest year on record was 2005,² and the top ten warmest years on record occurred in the past eleven years.³ The most active Atlantic hurricane season on record was in 2005, containing the most powerful hurricane ever recorded.⁴ Climate change, which occurs largely because of harmful greenhouse gas emissions,⁵ is causing these events and is not only dangerous, but is also extremely costly.⁶ Because climate change is such an immense threat, countries should control their emissions of carbon dioxide, the main greenhouse gas, otherwise, combating global warming will become even “more difficult and expensive.”⁷

To combat climate change, many countries joined the United Nations Framework Convention on Climate Change (“UNFCCC”) in 1992.⁸ The UNFCC Parties then adopted the Kyoto Protocol in

1. DEPARTMENT FOR ENVIRONMENT, FOOD AND RURAL AFFAIRS, AN OPERATOR’S GUIDE TO THE E.U. EMISSIONS TRADING SCHEME: THE STEPS TO COMPLIANCE 2 (2006), available at <http://www.defra.gov.uk/environment/climatechange/trading/eu/intro/euets-guide.pdf> [hereinafter OPERATOR’S GUIDE].

2. See The Climate Group, Climate Change Facts, <http://www.theclimategroup.org/index.php?pid=356> (last visited Feb. 1, 2007) (displaying statistics collected over recent years that show the effects of the climate change and some of its disastrous consequences).

3. See *id.* (reporting that 1996 was the only year of the past eleven that was not one of the top ten warmest years on record).

4. See *id.* (showing that in addition to the deadly European heat wave of 2003 and the disappearance of glaciers, climate change can cause other catastrophic effects such as hurricanes).

5. See United Nations Framework Convention on Climate Change art. 2, May 9, 1992, S. Treaty Doc. No. 102–38 (1992), 1771 U.N.T.S. 165, 168 [hereinafter UNFCCC] (defining greenhouse gases as “natural and anthropogenic” gases in the atmosphere that “absorb and re-emit infrared radiation”).

6. See *id.*; Steve Lohr, *The Cost of an Overheated Planet*, N.Y. TIMES, Dec. 12, 2006, at C1 (predicting the high costs of carbon dioxide emissions on future generations in the form of low farm output in poor countries, and an increased number of refugees fleeing stronger hurricanes and coastal floods).

7. See *id.* (revealing that even the chief executive of a coal-burning utility advocates federally regulating carbon dioxide emissions by imposing costs on its emission).

8. See UNFCCC, *supra* note 5, 1771 U.N.T.S. at 165 (recognizing the threat of global climate change and setting general goals to reduce greenhouse gas emissions in order to stabilize the concentration of such gases in the earth’s

1997.⁹ The Kyoto Protocol shares the UNFCCC's objectives, but strengthens them by adding legally binding targets of greenhouse gas emissions reductions.¹⁰ For example, the European Union must reduce emissions by eight percent.¹¹ To meet this target, the European Parliament and the Council of the European Union ("Council") established the European Union Emissions Trading Scheme ("E.U. Scheme") pursuant to Directive 2003/87/EC ("Directive").¹²

The purpose of emissions trading is to combat climate change by creating a market to provide efficient and practical solutions for reducing greenhouse gas emissions.¹³ Subsidies, however, defeat the objective of emissions trading by causing distortions in the market process.¹⁴ Subsidies decrease the efficiency with which an industry,

atmosphere at a "level that would prevent dangerous anthropogenic interference with the climate system").

9. Kyoto Protocol to the United Nations Framework Convention on Climate Change, Dec. 10, 1997, 37 I.L.M. 22 (1998) [hereinafter Kyoto Protocol].

10. *See id.* art. 2–3, Annex B, 37 I.L.M. at 32–34, 43 (stressing that the ultimate objective of the Kyoto Protocol is to reduce greenhouse gas emissions in pursuit of the ultimate objective of the UNFCCC, and listing the emissions standards for each country along with the rules for implementing those standards).

11. *See id.* Annex B, 37 I.L.M. at 43 (listing the specific emissions reduction targets for each Annex I country).

12. *See* Council Directive 2003/87, ¶ 5, 2003 O.J. (L 275) 32 (EC) (announcing that the objective of the E.U. Scheme is to help the European Union fulfill its reduction commitments under the Kyoto Protocol).

13. *See* GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, STATEMENT, NATIONAL IMPLEMENTATION OF THE E.U. EMISSIONS TRADING SCHEME, 1, 3–4 (Apr. 2006), available at <http://www.umweltrat.de/english/eframe01.htm> (explaining that the original purpose of emissions trading was to provide an economic incentive for countries and industries to operate in a more environment-friendly way by making carbon dioxide pollution a "production factor" whose costs must be accounted for when forecasting production amounts); *see also* Susan J. Kurkowski, *Distributing the Right to Pollute in the European Union: Efficiency, Equity, and the Environment*, 14 N.Y.U. ENVTL. L.J. 698, 704–05 (2006) (listing the five benefits that should result from emissions trading: (1) emissions reductions in a cost-effective manner; (2) higher compliance levels; (3) incentives for technological innovation; (4) reduced regulatory burdens; and (5) easier monitoring and enforcement); Lohr, *supra* note 6 (insisting that economic incentives are necessary for investment in cleanup and more fuel-efficient technological innovation).

14. *See infra* Part III.A.2 (concluding that, due to the E.U. Scheme granting its Member States discretion over their allocation of emissions allowances within their borders, Germany's current system of allocation is a potential subsidy and serves

or an installation,¹⁵ allocates its resources, thereby violating the spirit of the Kyoto Protocol.¹⁶

This comment acknowledges the potential benefits of the E.U. Scheme, but proposes an amendment to the Directive to prevent future subsidy claims the current setup could trigger. Part II briefly discusses the E.U. Scheme, National Allocation Plans (“NAPs”), and different methods of allocating emissions allowances. In addition, it discusses Germany’s NAP and the World Trade Organization’s (“WTO”) Agreement on Subsidies and Countervailing Measures (“SCM Agreement”).¹⁷ Part III analyzes the NAP of Germany and possible subsidy claims that could arise under the SCM Agreement. Part IV recommends that the Council modify the E.U. Scheme by imposing a uniform minimum level of scarcity and ensuring that the E.U. Member States¹⁸ use consistent methods of allocation. Part V concludes that although the E.U. Scheme is a good model for emissions trading in the international arena, it is imperfect, and thus the Council should amend it to avoid potential subsidy claims.

to distort the emissions market); *see also* Kurkowski, *supra* note 13, at 704–05 (listing one of the benefits of emissions trading as reducing greenhouse gas emissions in a cost-effective manner).

15. For purposes of this comment “installation” is defined as under Council Directive 2003/87. *See* Council Directive 2003/87, *supra* note 12, art. 3(e) (“[A] stationary technical unit where one or more activities listed in Annex I are carried out and any other directly associated activities which have a technical connection with the activities carried out on that site and which could have an effect on emissions and pollution.”).

16. *See* JOHN H. JACKSON, WILLIAM J. DAVEY & ALAN O. SYKES, *LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS*, 770 (4th ed. 2002) (explaining that the key issue in identifying subsidies, or any government measure, is determining whether those measures are distorting or correcting the market process).

17. *See* Marrakesh Agreement Establishing the World Trade Organization, Annex IA. Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, 1869 U.N.T.S. 14 [hereinafter *SCM Agreement*] (defining “subsidy” for the purposes of the World Trade Organization); *infra* Part II B–C.

18. Throughout this comment, a “Member State” refers to a country that is a part of the European Union, while a “Member Country” refers to a country that is a part of the WTO. As it turns out, all Member States of the European Union are Member Countries of the WTO.

II. BACKGROUND

On February 16, 2005, the Kyoto Protocol entered into force.¹⁹ It became legally binding when at least “55 Parties to the Convention [the UNFCCC], incorporating Parties included in Annex I which accounted in total for at least 55 per cent of the total carbon dioxide emissions for 1990 of the Parties included in Annex I²⁰ ratified the Kyoto Protocol.²¹ The Kyoto Protocol made the emissions reductions goals listed in Annex B²² binding on the countries that ratified it. Annex B assigns emissions allowances, or rights to emit gases,²³ to the countries in order to promote the UNFCCC’s mission of

19. See Press Release, United Nations Environment Programme [UNEP], Kyoto Protocol to Enter into Force 16 February 2005 (Nov. 18, 2004), available at <http://www.unep.org/Documents.Multilingual/Default.asp?DocumentID=412&ArticleID=4669&l=en> (announcing that the Kyoto Protocol was entering into force and would become legally binding on its 128 Parties ninety days after the Russian Federation ratified it on November 18, 2004).

20. See UNFCCC, *supra* note 5, Annex I, 1771 U.N.T.S. at 189 (listing the developed or industrialized countries, such as Austria, Canada, Denmark, New Zealand, Turkey, and the United States, in Annex I of the UNFCCC).

21. See Kyoto Protocol, *supra* note 9, art. 24, 37 I.L.M. at 41 (explaining that the Kyoto Protocol was only to become binding on the ninetieth day after the two conditions were met and each party had deposited its instruments of ratification, acceptance, approval, or accession).

22. See *id.* Annex B, 37 I.L.M. at 43 (enumerating all of the developed countries listed in Annex I of the UNFCCC except for two, Belarus and Turkey, along with each country’s “quantified emission limitation or reduction commitment”); *id.* art. 3(1), 37 I.L.M. at 33 (mandating that all Annex I countries not exceed their allowed amounts of greenhouse gas emissions, which are calculated according to their limitation and reduction commitments listed in Annex B).

23. See Council Directive 2003/87, *supra* note 12, art. 3(a) (defining an allowance as “an allowance to emit one tonne of carbon dioxide equivalent during a specified period”). *But see* Kirk W. Junker, *Ethical Emissions Trading and the Law*, 13 U. BALT. J. ENVTL. L. 149, 150, 152–53 (2006) (pointing out that the definition of allowances in the United States Clean Air Act does not define emissions allowances as property rights, but instead characterizes them as transferable authorizations to emit gases. See generally Daveed Garenstein-Ross, *An Analysis of the Rights-Based Justification for Federal Intervention in Environmental Regulation*, 14 DUKE ENVTL. L. & POL’Y F. 185, 187 (2003); Gerald Torres, *Who Owns the Sky?*, 19 PACE ENVTL. L. REV. 515, 517 (2002); Daniel H. Cole, *Clearing the Air: Four Propositions about Property Rights and Environmental Protection*, 10 DUKE ENVTL. L. & POL’Y F. 103, 105 (1999) (discussing the general concept of property rights relating to environmental regulation).

stabilizing greenhouse gas concentrations²⁴ in the atmosphere at a level that will prevent harmful interference with the climate system.²⁵

The Kyoto Protocol contains three mechanisms²⁶ that Annex I countries can use to comply with the reduction requirements of Annex B.²⁷ The first two mechanisms, the “joint implementation mechanism”²⁸ and the “clean development mechanism,”²⁹ involve

24. See UNFCCC, *supra* note 5, art. 1(5), 1771 U.N.T.S. at 168 (defining greenhouse gases); see also Kyoto Protocol, *supra* note 9, Annex A, 37 I.L.M. at 42 (listing the greenhouse gases included for emissions reductions purposes: carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons, and sulphur hexafluoride).

25. See UNFCCC, *supra* note 5, art. 2, 1771 U.N.T.S. at 169 (elaborating that countries can achieve the ultimate objective of the UNFCCC by stabilizing the level of greenhouse gas emissions within a period of time that is sufficient to “allow ecosystems to adapt naturally to climate change,” and to guarantee that resources for food production and economic development continue to thrive in a sustainable manner).

26. See Kyoto Protocol, *supra* note 9, arts. 6, 12, 16 bis, 37 I.L.M. at 35, 38, 40 (setting out the three different mechanisms: the joint implementation mechanism, clean development mechanism, and emissions trading).

27. See *id.* Annex A, B, 37 I.L.M. at 42, 43 (listing the numerical reduction requirements to which all Annex B countries must adhere and the sectors or source categories that are subject to emissions reductions: energy; industrial processes; solvent and other product use; agriculture; and waste).

28. See *id.* art. 6, 37 I.L.M. at 35 (discussing the joint implementation mechanism, which allows Annex I countries to transfer and acquire emissions reductions units, as long as they are the products of certain projects that aim specifically at reducing emissions, from other Annex I countries to meet their Annex B and Article 3 obligations under the Kyoto Protocol). The joint implementation mechanism projects are subject to certain conditions: (1) the countries involved must approve them; (2) the countries must ensure that the reduction of emissions are additional to any reduction that would otherwise occur; (3) the acquiring country must be in compliance with its obligations under Articles 5 and 7 of the Kyoto Protocol; and (4) the countries must ensure that the “acquisition of emission reduction units” are in addition to domestic actions that they undertake to meet the commitments set forth in Article 3. *Id.*

29. See *id.* art. 12, 37 I.L.M. at 38 (noting that the second mechanism, the clean development mechanism, encourages Annex I countries to assist countries not listed in Annex I—the developing countries—in achieving and contributing to sustainable development by funding projects in these countries). Participating Annex I countries can use the certified emissions reductions resulting from the projects to meet their own emissions reductions commitments. Clean development mechanism projects are subject to certain conditions: (1) the voluntary participation of the countries involved; (2) a showing of “real, measurable long-term benefits” for the climate; and (3) the reductions must be additional to any reductions that would otherwise occur in the absence of a funded project. *Id.*

special projects that facilitate emissions reductions. The third mechanism permits Annex B countries to trade emissions allowances to fulfill their commitments under Article 3 of the Kyoto Protocol.³⁰ The Council established the Directive in order to create a system that would help Member States achieve their Annex B commitments³¹ using the third mechanism—“emissions trading.”³²

A. THE EUROPEAN UNION EMISSIONS TRADING SCHEME AND NATIONAL ALLOCATION PLANS

Under the Kyoto Protocol, the European Union committed to an aggregate eight percent reduction³³ of greenhouse gas emissions from 1990 levels during the first commitment period of the Kyoto Protocol, 2008 to 2012.³⁴ The E.U. Scheme allows for the allocation and trade of greenhouse gas emissions allowances.³⁵ It provides for

30. *See id.* art. 16 bis, 37 I.L.M. at 40 (mandating that, as with joint implementation and clean development mechanisms, countries make emissions trading supplemental to domestic actions that they undertake to meet their reductions commitments specified in Article 3). Countries may add emissions reduction units, or any part of an assigned amount of emissions allowances, which they acquire from another country using the clean development mechanism, to their assigned amounts. Alternatively, if a country transfers emissions reduction units to another country using the joint implementation or emissions trading mechanisms, it may subtract them from its assigned amounts. *Id.* art. 3(10)–(13), 37 I.L.M. at 33.

31. *See* Council Directive 2003/87, *supra* note 12, ¶¶ 3–4 (defining the UNFCCC’s objective as the achievement of the stabilization of atmospheric greenhouse gases at the reduced levels that Annex B of the Kyoto Protocol assigned to the countries that ratified it).

32. *See* Cinnamon Carlarne, *Climate Change Policies an Ocean Apart: EU and US Climate Change Policies Compared*, 14 PENN ST. ENVTL. L. REV. 435, 465 (2006) (explaining that the E.U. Scheme is supplemental to the national programs of Member States, as well as to their participation in the first two mechanisms in the Kyoto Protocol—the joint implementation mechanism and clean development mechanism projects).

33. *See* Kyoto Protocol, *supra* note 9, Annex B, 37 I.L.M. at 43 (showing that the European Union, as a whole, committed to an aggregate eight percent reduction, individual countries of the European Union also have individual reduction commitments in Annex B).

34. *See* Council Directive 2003/87, *supra* note 12, ¶4.

35. *See* OPERATOR’S GUIDE, *supra* note 1, at 2–4 (highlighting how the “market-based” approach allows installations discretion to buy and sell allowances according to their needs but simultaneously ensures that installations do not exceed their allocated emissions). The E.U. Scheme is implemented by requiring Member States to make the Directive part of their national legislation. *Id.* at 4.

the flexibility, which the Kyoto Protocol envisioned,³⁶ to buy additional allowances or sell surplus allowances.³⁷ Pursuant to the Directive, Member States decide on the total quantity and allocation of allowances to each installation that the Directive covers.³⁸

The E.U. Scheme is one of the most significant policies that the European Union has enacted to reduce greenhouse gas emissions. The E.U. Scheme covers specified installations, mostly in the energy production sector.³⁹ They total to over 11,400 installations throughout the European Union, and are responsible for about half of all carbon dioxide emissions in the European Union.⁴⁰ About 1,849 of the installations are located in Germany,⁴¹ and these installations account for fifty-nine percent of the country's carbon dioxide emissions.⁴²

Under the Directive, an allowance consists of the right to emit one ton of carbon dioxide or its equivalent⁴³ during a specific time period.⁴⁴ Phase I, which runs from 2005 to 2007,⁴⁵ is the "learning phase" of the E.U. Scheme,⁴⁶ allowing Member States an opportunity

36. See Kyoto Protocol, *supra* note 9, art. 16 bis, 37 I.L.M. at 40 (noting that trading "shall be supplemental to domestic actions for the purpose of meeting quantified emission limitation and reduction commitments under that Article").

37. OPERATOR'S GUIDE, *supra* note 1, at 2.

38. See Council Directive 2003/87, *supra* note 12, arts. 9(1), 11(1)–(2) (referring Member States to Annex III of the Directive, which provides them with eleven general criteria to follow when they devise their individual NAPs).

39. See GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 7 (defining the energy production sector as one that emits over twenty megawatts of heat output).

40. See *id.*; Kurkowski, *supra* note 13, at 699–700 (elaborating on the unprecedented scope of the E.U. Scheme, which is not only the first multinational emissions trading scheme, but also the first large-scale carbon dioxide emissions trading system in the world).

41. See GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 7.

42. See *id.* (suggesting that Germany will allocate its carbon dioxide emissions free of charge until 2008, in line with the Directive's mandate).

43. See Council Directive 2003/87, *supra* note 12, art. 3(a).

44. See *id.* art. 3(a) (maintaining that the allowance is valid "only for the purposes of meeting the requirements of [the] Directive and shall be transferable in accordance with the provisions of [the] Directive").

45. See *id.* art. 10 (noting that during the initial three-year period, Member States "shall allocate at least 95% of the allowances free of charge").

46. See Kurkowski, *supra* note 13, at 706 (identifying the participating industries in the "learning phase" as "energy and major emitting industrials").

to accustom themselves to trading before the first Kyoto Protocol commitment period.⁴⁷ Phase II of the E.U. Scheme runs simultaneously with the first Kyoto Protocol commitment period, 2008 to 2012.⁴⁸

The E.U. Scheme requires each Member State to develop a NAP that contains the total amount of emissions allowances that the Member State plans to allocate, as well as the ways in which it wishes to allocate them.⁴⁹ The Directive also mandates that the Member States base their NAPs on “objective and transparent criteria,” and “take due account of comments from the public.”⁵⁰ Member States must then submit their NAPs to the Council for approval.⁵¹ The Council can reject a NAP within three months of its submission if the NAP does not conform to the specified guidelines.⁵²

Each NAP consists of a Macroplan and a Microplan.⁵³ A Macroplan defines the total emissions budget for the Member State

47. *See id.*; *see also* Inho Choi, *Global Climate Change and the Use of Economic Approaches: The Ideal Design Features of Domestic Greenhouse Gas Emissions Trading with an Analysis of the European Union's CO₂ Emissions Trading Directive and the Climate Stewardship Act*, 45 NAT. RESOURCES J. 865, 913 (2005) (explaining that the four industries participating in Phase I of the E.U. Scheme include: iron and steel production and processing; minerals industries; electricity and refineries; and pulp and paper).

48. *See* Council Directive 2003/87, *supra* note 12, art. 10 (noting that during Phase II, “Member States shall allocate 90% of the allowances free of charge”); *see also* Carlarne, *supra* note 32, at 464 (explaining that Phase I includes only carbon dioxide emissions, but Phase II includes emissions of other greenhouse gases)

49. *See id.* art. 9 (providing guidelines that Member States should follow when they devise their NAPs for each period identified in Articles 11(1) and (2)).

50. *See id.* art. 9(3) (referring Member States to Annex III for further guidelines on developing their NAPs).

51. *See* GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 7 (explaining that NAPs must comply with a range of requirements that the Directive sets forth, and offering as an example the requirement that reduction targets take into account obligations under the Kyoto Protocol).

52. *See* Council Directive 2003/87, *supra* note 12, art. 9(3) (mandating that the Commission provide the reasons for rejection to the Member State if its NAP is incompatible with the criteria listed under Article 10 and Annex III).

53. *See, e.g.*, FEDERAL MINISTRY FOR THE ENVIRONMENT, NATURE CONSERVATION AND NUCLEAR SAFETY, NATIONAL ALLOCATION PLAN FOR THE FEDERAL REPUBLIC OF GERMANY 2005–2007, at 6 (2004) [hereinafter GERMAN NAP].

and determines the total quantity of allowances that the government intends to distribute.⁵⁴ A Microplan details how the government plans to distribute allowances to each of the participating installations.⁵⁵

B. THE GERMAN NATIONAL ALLOCATION PLAN AND ITS STEEL INDUSTRY

Germany based its emissions budget for its Macroplan on its target for the first reduction commitment of the Kyoto Protocol,⁵⁶ as well as on the burden-sharing agreement within the European Union.⁵⁷ During Phase I, the E.U. Scheme confines emissions trading only to carbon dioxide.⁵⁸ Germany distributed one-hundred percent of its emissions allowances free of charge during Phase I.⁵⁹ During Phase

54. *See id.* at 6, 12 (explaining that Germany's Macroplan directs the dispersion of the national emissions budget between various greenhouse gases, emissions trading segments, and to other sources consistent with its "national climate protection targets").

55. *See id.* at 6, 7 (elaborating that the Microplan "defines the methods, rules, and criteria" for allocation decisions, as well as the quantity of emissions allowances that the Member State will grant to each of the individual installations).

56. *See id.* at 6 (stating that for the Phase II, Germany must reduce emissions by twenty-one percent compared to 1990 levels). The Macroplan supports the requirements of the E.U. reductions budget by breaking down the emissions allowances by type of greenhouse gas and sector. *Id.*

57. *See* Kurkowski, *supra* note 13, at 705–08 (describing how the burden-sharing agreement distributes among Member States the eight percent required reduction from 1990 emissions levels in accordance with each country's expectation for economic growth). For example, it requires Germany, a country of great relative wealth, to make a twenty-one percent reduction from 1990 levels, while allowing the less well-off Greece to actually increase its emissions twenty-five percent above 1990 levels. *Id.* at 706. *See also* Paul Q. Watchman, *Background to the EU ETS*, in *INTERNATIONAL ENVIRONMENTAL LAW* 191, 194 (J. William Futrelle et al. eds., 2006) (noting that all twenty-five Member States of the European Union have reduction commitments, however only the original fifteen have commitments under the burden-sharing agreement). All the new members must reduce their emissions by eight percent of 1990 levels, except for Hungary and Poland, which must reduce their emissions by six percent of 1990 levels. *Id.*

58. *See* GERMAN NAP, *supra* note 53, at 6, 13 (cautioning, however, that the Macroplan must provide for compensatory measures to combat unexpected changes in the emission of other gases that may occur in response to restrictions on CO₂ emissions).

59. *See id.* at 4 (explaining that Article 10 of the Directive requires Member States to allocate at least ninety-five percent of emissions allowances free of charge during Phase 1).

II, Germany once again plans to distribute one-hundred percent of the allowances free of charge.⁶⁰ It will only charge for the costs of issuing and distributing emissions certificates and for any costs that arise in connection with the maintenance of a registry of allowances.⁶¹

During Phase I, the German NAP includes only certain industries and installations.⁶² The energy and industry sectors comprise most of the installations participating during Phase I.⁶³ Moreover, the E.U. Scheme does not allow two sectors, transport and households, to participate in emissions trading.⁶⁴

The E.U. Scheme allows for many different methods of allocating allowances.⁶⁵ The “grandfathering method” allows Member States to base allocation on historic emissions levels,⁶⁶ so the amount of

60. *See id.* at 21.

61. *See id.* at 4 n.2.

62. *See id.* at 9, 11 (explaining that whether an installation is subject to emissions trading will depend on whether it falls within one of the categories in Germany’s “list of relevant installations,” including “energy generation and conversion,” “production and processing of ferrous metals,” “mineral industry,” and “other industrial activities”).

63. *See id.* at 19.

64. *See id.* at 20 (rationalizing that the German government has undertaken different measures and policies to reduce the amount of harmful greenhouse gas emissions in these sectors); *see also* Kurkowski, *supra* note 13, at 706–07 (explaining that because the E.U. Scheme includes emissions from non-trading sectors in the aggregate reductions requirements, when devising NAPs and allocating emissions allowances, Member States will take any potential reductions from these non-trading sectors into account).

65. *See* Annie Petsonk, *The Kyoto Protocol and the WTO: Integrating the Greenhouse Gas Emissions Allowance Trading into the Global Marketplace*, 10 DUKE ENVTL. L. & POL’Y F. 185, 206–08 (2000) (contending that every country may select the way in which it allocates the burden of emissions limits, “regardless of the form of environmental regulation,” and despite the fact that certain methods may “favor some groups over others”); *see also* European Comm’n, Working 3 Monitoring Mechanism Comm., Non-Paper, *The EU Emissions Trading Scheme: How to Develop a National Allocation Plan*, 5, Apr. 1, 2003 [hereinafter *How to Develop a NAP*].

66. *See* Petsonk, *supra* note 65, at 207 (explaining that under the grandfathering approach countries may subdivide their emissions allocations into either “upstream” or “downstream” allocations); *see also* *How to Develop a NAP*, *supra* note 65, at 4 (emphasizing that under such an approach, a Member State will distribute some or all of its emissions allowances among the participating industries and installations according to the shares of their historic emissions levels during a particular year, and then it will multiply that number by the total amount

emissions that the installations emitted during a specific period determines allocation.⁶⁷ Under the “auction method” of allocation, a Member State auctions its allowances for the commitment period to the highest bidders.⁶⁸ The “benchmarking method” allows Member States to base individual allocations of allowances on “the average specific emissions of a product category.”⁶⁹

Different rules and procedures, such as banking,⁷⁰ govern the allocation of emissions allowances under different circumstances.⁷¹

of emissions available).

67. See CLIMATE ACTION NETWORK EUROPE, NATIONAL ALLOCATION PLANS 2005–7: DO THEY DELIVER? 24 (2006), available at www.climnet.org [hereinafter CAN EUROPE] (pointing out that the E.U. Scheme does not define specific base years for Member States to use for allocations). This is problematic because Member States tend to choose a calculation of base years that ensures above average base levels of emissions, resulting in a greater allocation of emissions allowances and leading to “additional distortions and complaints about fairness within countries and across borders.” *Id.* at 24–25.

68. See *id.* at 27 (recommending that Member States distribute emissions allowances using the auction method, so the “polluter pays principle” can be fully implemented” in the E.U. Scheme). In addition, the auction method has major advantages over the grandfathering and benchmark methods because it generates revenue for the government and provides the biggest incentive for installations to reduce emissions so they do not have to pay for more emissions allowances. *Id.* See also Petsonk, *supra* note 65, at 207 (elaborating that governments can hold auctions more than once, and even during the commitment period).

69. GERMAN NAP, *supra* note 53, at 7; see CAN EUROPE, *supra* note 67, at 25 (clarifying that the Benchmarking Method is “inherently sector or even sub-sector specific,” and emphasizing that Member States should not make benchmarks fuel-specific, but should make them product-specific); see also GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 10 (criticizing the fuel-specific method because when benchmarks focus on the best-available technology at a particular installation, this results in differing allocations for fuel, such as coal and gas). This fuel-specific method reduces the incentive for installations to switch from coal and gas to fuels that are more efficient. *Id.*

70. See GERMAN NAP, *supra* note 53, at 43 (explaining that the Directive permits Member States to transfer, or “bank,” unused allowances at the end of a trading period on to the next period). The German NAP does not permit installations to bank the unused allowances from Phase I and use them in Phase II because the banking of allowances would increase the total allowances distributed during the Kyoto Protocol commitment period 2008 to 2012. *Id.* at 43–44. Furthermore, the lack of harmonization of banking arrangements throughout the European Union would make it harder for a Member State to achieve its Kyoto Protocol target. *Id.* at 43.

71. See *id.* at 21 (explaining that the transfer rule and the new entrant rule govern the allocation of emissions allowances to certain existing and new installations, and the closure rule allows for the modification of the allowances that

Special rules may apply “for installations that achieved early emissions reductions (early actions), for process-related emissions, for installations using combined heat and power, and for closure of nuclear power plants.”⁷² These special rules cause regulatory uncertainty because they result in allocations that exceed the forecasted budget.⁷³

Germany allocated allowances using the grandfathering method and the benchmarking method.⁷⁴ In addition, it applied special rules to its steel industry, regulating it under “process-related emissions” because the release of carbon dioxide results from “a chemical reaction other than combustion.”⁷⁵ Therefore, Germany granted these types of processes special treatment⁷⁶ when it assigned and allocated emissions allowances.⁷⁷

Member States issued to decommissioned installations, whose allowances are not transferable to new installations). The transfer rule allows for the transfer of emissions from installations that Member States decommissioned to installations commissioned starting January 1, 2005, and the new entrant rule allows for the allocation of free allowances to installations that are not eligible to receive allowances through the transfer rule. *Id.* In addition, Member States modify the issuance of allowances in conjunction with certain “capacity utilisation adjustment rules.” *Id.*

72. GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 11 (internal cross-references omitted).

73. *See id.* at 11–12 (suggesting that the special allocation rules also result in installations postponing investment into more energy-efficient equipment and activities). This results in higher future allocations of emissions allowances and lower liquidity in current emissions trading. *Id.*

74. *See id.* (explaining that the German government will use emissions data from the 2000 to 2002 reference period when it calculates the allocation of allowances under the grandfathering and the benchmarking methods).

75. *Id.* at 39 (manufacture of oxygen steel and pig iron production).

76. *See id.* (distinguishing process-related emissions from energy-related emissions, which the government calculates on the basis of the rules in Section C.6 of the German NAP and which uses the generally applicable compliance factor).

77. *See id.* at 39–40 (elaborating that Annex III of the Directive gives Member States the basis on which to grant special treatment, and it instructs that governments take into account the “technological potential for reductions”).

C. SUBSIDY CLAIMS ARISING UNDER THE AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES

In international trade, two categories of subsidies exist: domestic and export.⁷⁸ A domestic subsidy arises when the government grants a financial contribution to an industry, regardless of whether the industry exports its products.⁷⁹ An export subsidy occurs when the government pays an industry only for the products it actually exports.⁸⁰ The main issue regarding subsidies is not whether the governmental measures cause distortions, but whether the measures positively or negatively effect the efficiency with which an industry allocates resources.⁸¹

Article 1.1 of the SCM Agreement, which is a WTO⁸² trade agreement, details that a subsidy exists when a government makes a “financial contribution” to an industry within its territory.⁸³ A subsidy can occur if the practice in question involves a “direct transfer of funds,” such as “grants, loans, and equity infusion,” or a “potential direct transfer of funds or liabilities.”⁸⁴ It can also occur if the government provides “any form of income or price support.”⁸⁵ But, most importantly, the financial contribution must result in a “benefit... conferred” to the subsidizing Member Country’s

78. JACKSON, DAVEY & SYKES, *supra* note 16, at 767.

79. *See id.* at 767–68 (defining a domestic subsidy and explaining that a subsidy is a protectionist measure because it lowers prices on domestic products below prices of competing foreign products).

80. *See id.* at 768 (asserting that in the case of export subsidies, exporters can sell goods in other countries at a price below the domestic price for the same goods, resulting in an uneconomic allocation of resources).

81. *Id.* at 770.

82. *See* Marrakesh Agreement Establishing the World Trade Organization PmbL., Apr. 15, 1994, 1867 U.N.T.S. 3 (reaffirming the WTO’s commitments to “develop an integrated, more viable and durable multilateral trading system,” while “allowing for the optimal use of the world’s resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment”). *See generally* JACKSON, DAVEY & SYKES, *supra* note 16, at 208–09 (discussing the evolution of the WTO from the General Agreement on Tariffs and Trade of 1947 (“GATT”), a provisional international trade treaty).

83. *See* SCM Agreement, *supra* note 17, art. 1.1, 1869 U.N.T.S. at 14 (defining “subsidy” for the purposes of the World Trade Organization).

84. *Id.* art. 1.1(a)(1)(i), 1869 U.N.T.S. at 14.

85. *Id.* art. 1.1(a)(2), 1869 U.N.T.S. at 14 (referring to the definition of income or price support in Article XVI of GATT 1994).

industry.⁸⁶ The WTO Appellate Body analyzed this provision in *Canada—Measures Affecting the Export of Civilian Aircraft*, and interpreted “benefit” as an advantage to the recipient in the market.⁸⁷

The SCM Agreement defines three categories of subsidies in Articles 3, 5, and 8.⁸⁸ The first category consists of prohibited subsidies, which are export subsidies.⁸⁹ The second consists of actionable subsidies, which cause “adverse effects” to the interests of another Member Country.⁹⁰ Finally, the third category consists of non-actionable subsidies,⁹¹ which are a limited category of subsidies

86. *Id.* art. 1.1(b), 1869 U.N.T.S. at 14.

87. See Appellate Body Report, *Canada—Measures Affecting the Export of Civilian Aircraft*, ¶¶ 149–61, WT/DS70/AB/R (Aug. 2, 1999) [hereinafter *Canada—Civilian Aircraft*] (upholding the Panel’s interpretation of a benefit, and stressing that the benefit does not have to be conferred to the granting authority or government).

88. SCM Agreement, *supra* note 17, arts. 3, 5, 8, 1869 U.N.T.S. at 16, 18, 22–24; see also *id.* arts. 4, 7, 9, 1869 U.N.T.S. at 16–17, 20–22, 25 (assigning differing remedies to violations of each of the specific types of subsidies because of differing degrees of harm to the complaining Member Country, or degrees of benefits conferred to the subsidizing Member Country).

89. See *id.* art. 3, 1869 U.N.T.S. at 16 (providing that this type of subsidy must be contingent on export performance, or on the use of domestic over imported products); see also OFFICE OF THE U.S. TRADE REPRESENTATIVE, EXECUTIVE OFFICE OF THE PRESIDENT, STATEMENT OF ADMINISTRATIVE ACTION, THE URUGUAY ROUND AGREEMENTS ACT: AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES (1994) [hereinafter USTR STATEMENT] (pointing out that to challenge this type of subsidy, a Member Country must only prove the existence of the subsidy, but does not have to demonstrate that the subsidy has any adverse trade effects); Petsonk, *supra* note 65, at 205 (explaining that the WTO subjects prohibited subsidies to an “expedited timetable for action by the Dispute Settlement body,” so if it finds a prohibited subsidy, the subsidizing Member Country must immediately withdraw it or the complaining Member Country can take appropriate countermeasures).

90. See SCM Agreement, *supra* note 17, art. 5, 1869 U.N.T.S. at 18 (stressing that no Member Country can act in a way that will cause adverse effects to the interests of others by: injuring the domestic industry of another Member Country; “nullifying or impairing” the benefits accruing, either directly or indirectly, to another Member Country; or by seriously prejudicing the interests of another Member Country).

91. See *id.* art. 8, 1869 U.N.T.S. at 23–24 (describing in detail the different situations under which a panel may characterize subsidies as non-actionable subsidies); see also Petsonk, *supra* note 65, at 205–06 (elaborating on the types of possible specific subsidies that involve assistance, such as: support for industrial research; development activities in disadvantaged regions; or assistance for adapting existing facilities to meet environmental requirements that new

that are not actionable if they meet the strict criteria enumerated in the SCM Agreement,⁹² particularly in Article 8.2(c).⁹³

If a Member Country believes that another Member Country's measure is a subsidy, it must first conduct consultations with the suspected Member Country.⁹⁴ If consultations are not successful, the complaining Member Country can request that a panel hear its claim.⁹⁵ The panel will make a decision and order a remedy if appropriate.⁹⁶ Both Member Countries will have the opportunity to appeal the panel decision to the Appellate Body.⁹⁷

III. ANALYSIS

Germany's allocation of free emissions allowances is a subsidy because it constitutes a financial contribution by the government and a benefit is conferred to the installations that receive the financial contribution, which is the allocation of free emissions allowances.⁹⁸ Once a panel concludes that a particular measure is a subsidy, it must determine what type of subsidy the measure constitutes.⁹⁹ In this

regulations impose).

92. See USTR STATEMENT, *supra* note 89 (listing and analyzing the criteria for the three types of non-actionable subsidies: research subsidies; subsidies to disadvantaged regions; and subsidies for environmental adaptation).

93. SCM Agreement, *supra* note 17, art. 8.2(c), 1869 U.N.T.S. at 24.

94. See JACKSON, DAVEY & SYKES, *supra* note 16, at 259 (hypothesizing that the WTO's Dispute Settlement Understanding requires consultations to allow Member Countries to resolve disputes without resorting to formal dispute settlement procedures).

95. See General Agreement on Tariffs and Trade: Multilateral Trade Negotiations Final Act Embodying the Results of the Uruguay Round of Trade Negotiations, Annex 2, Understanding on Rules and Procedures Governing the Settlement of Disputes, art. 4.7, Apr. 15, 1994, 33 I.L.M. 1125, 1229 (1994) [hereinafter Understanding on Rules and Procedures] (providing a sixty day timeframe for countries to settle a dispute with consultations).

96. See *id.* art. 11, 33 I.L.M. at 1233 (requiring panels to make an "objective assessment" of the issues in regard to the facts of the particular cases and relevant provisions in dispute). In addition, panels should submit final reports within six months, or in emergencies, within three months. *Id.* art. 12.8., 33 I.L.M. at 1234.

97. See *id.* art. 17.1, 33 I.L.M. at 1236

98. See SCM Agreement, *supra* note 17, art. 1.1, 1869 U.N.T.S. at 14 (providing that a subsidy could exist if not just the government, but "any public body within the territory of a Member," makes a financial contribution and a benefit is conferred).

99. See *id.* arts. 4, 7, 9, 1869 U.N.T.S. at 16–17, 20–22, 25 (providing a

case, a panel could find that the allocation of free emissions allowances is either an actionable subsidy¹⁰⁰ or a non-actionable subsidy.¹⁰¹

A. GERMANY'S ALLOCATION OF FREE EMISSIONS ALLOWANCES
COULD CONSTITUTE A SUBSIDY AS DEFINED BY ARTICLE 1.1 OF
THE SCM AGREEMENT

Germany's allocation of free emissions allowances pursuant to its NAP could constitute a subsidy. Under the SCM Agreement, a subsidy results when a government makes a "financial contribution" to an industry within its territory and a "benefit is... conferred" to the subsidized industry.¹⁰² A WTO panel must ultimately assess whether a governmental measure meets these two conditions.¹⁰³

1. *The Allocation of Free Allowances Constitutes a Distribution of a
"Financial Contribution"*

The first and most important question regarding the allocations of free allowances is whether a WTO panel would hold that these allowances are financial contributions.¹⁰⁴ When Germany allocates

consultation process for dispute resolution and remedies due once the Members determine the type of subsidy that a measure constitutes).

100. *See id.* art. 5, 1869 U.N.T.S. at 18 (defining an actionable subsidy as one that is "specific" and causes "adverse effects to the interests" of other Member Countries).

101. *See id.* art. 8.1, 1869 U.N.T.S. at 22 (identifying non-actionable subsidies as those that are not "specific," according to Article 2, or those that are "specific" but fall within one of the three categories and meet the conditions that Article 8.2 outlines).

102. *Id.* art. 1, 1869 U.N.T.S. at 14; *see* JACKSON, DAVEY & SYKES, *supra* note 16, at 780 (clarifying that WTO law generally characterizes subsidies as the benefit to the recipient, rather than the cost to the subsidizing government, because a "cost to the government" interpretation would exclude situations where a private body under the government's direction confers a "benefit").

103. *See* JACKSON DAVEY & SYKES, *supra* note 16, at 260 (discussing the WTO Dispute Settlement Understanding, and indicating that a panel is composed of three individuals who serve not as representatives of their countries, but in their individual capacities, and many of whom are government officials, former Secretariat officials, trade academics, or trade lawyers). The WTO Dispute Settlement Understanding dictates that the panel examines the matter at issue "in light of the relevant provisions" at dispute, makes appropriate findings and recommendations, or gives rulings. *Id.* at 261.

104. *See* SCM Agreement, *supra* note 17, art. 1.1, 1869 U.N.T.S. at 14

free emissions allowances to industries, specifically the steel industry and its participating installations, the installations receive windfall benefits.¹⁰⁵ Essentially, Germany is allocating significant assets to the installations.¹⁰⁶ As a result, Germany is granting financial contributions to the steel industry.¹⁰⁷

When a country allocates emissions allowances, it alters the asset base of an installation.¹⁰⁸ In an efficient emissions trading system, installations have incentives to take measures to reduce emissions, such as investing in more efficient and less carbon intensive technology to become more competitive.¹⁰⁹ However, when Germany grants free emissions allowances, installations receive windfall profits, regardless of any improved competitive position or profitability.¹¹⁰

The German steel installations will automatically have an advantage over steel installations in other Member States, whose

(elaborating on various circumstances under which a government can make a financial contribution). *But see* Petsonk, *supra* note 65, at 208 (theorizing that a WTO panel would probably answer this initial question in the negative).

105. *See* GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 2.

106. *See id.* (analogizing the allocation of free emissions allowances with the allocation of assets to the businesses and installations that receive them).

107. *See id.* at 16 (characterizing the allocation of free allowances as an “across-the-board subsidy” because the emissions allowances are not linked to the business’s output and so changes its asset values). *But see* Petsonk, *supra* note 65, at 208–09 (arguing that characterizing allocations as subsidies would be the same as saying that “any allocation of any type of responsibility for regulation,” either domestic or international, would also constitute a subsidy).

108. *See* GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 2 (arguing that a government will alter the asset base of an installation if it distributes emissions allowances free of charge, and this alteration will be independent of the installation’s new level of profitability, therefore, having nothing to do with an increased ability to make profits).

109. *See* CAN EUROPE, *supra* note 67, at 27 (indicating that installations reduce emissions by lowering their consumption of and demand for energy). Although requiring installations to pay for emissions is costly in the short run, the “polluter pays principle” provides the biggest incentive for installations to reduce emissions, and therefore results in the most effective emissions trading system in the long-run. *Id.*

110. *See* GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 2 (explaining the dangers, or “allocation battles,” of allocating emissions allowances to installations and industries free of charge).

governments do not allocate emissions allowances free of charge.¹¹¹ Germany limits the regulatory burdens of the installations when it provides them with free emissions allowances.¹¹² These installations, in turn, can sell to installations in other Member States that have higher regulatory burdens to meet.¹¹³

The installations in other Member States will have to pay German steel installations a monetary value for the emissions allowances that they buy.¹¹⁴ Therefore, because German steel installations can sell emissions allowances on the market to competing installations in other Member States,¹¹⁵ their emissions allowances represent a monetary value. Thus, Germany's practice of allocating emissions allowances free of charge constitutes a financial contribution because it involves "a direct transfer of funds."¹¹⁶

111. See Council Directive 2003/87, *supra* note 12, art. 10 (mandating that during Phase I, governments must allocate at least ninety-five percent of emissions allowances free of charge, and during Phase II, decreasing the number to at least ninety percent of emissions allowances that governments must allocate free of charge).

112. See Kurkowski, *supra* note 13, at 702 (describing the competitive advantage of installations that receive emissions allowances free of charge). *But see* GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 16 (construing competitiveness as the "ability to make a profit from business activities," and reasoning that free allowances do not impact competitiveness because they alter the "price for all installations equally").

113. Kurkowski, *supra* note 13, at 702.

114. See *id.* at 717 (explaining that capital flows from the installation that has to buy allowances from an installation in another Member State—the importer of allowances—to the German installation selling the allowances—the exporter of allowances); see also GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 3 (analogizing that the legislature has, in effect, made carbon dioxide emissions allowances "a tradable good").

115. See Kurkowski, *supra* note 13, at 704 (introducing emissions trading as a "cap-and-trade" scheme where firms have the choice of keeping emissions at or below a certain cap by investing in better technology, or buying emissions allowances on the market to remain below the cap; thus a marketplace develops for these purchases).

116. See SCM Agreement, *supra* note 17, art. 1.1(a)(1)(i), 1869 U.N.T.S. at 14.

2. *Because the Emissions Allowances Do Not Reflect Market Value and Thus, Distort the Free Market System, a “Benefit is... Conferred” to the German Steel Industry*

Germany’s financial contribution, resulting from its allocation of free emissions allowances, results in a benefit conferred to its steel industry.¹¹⁷ In *Canada—Measures Affecting the Export of Civilian Aircraft*, the Appellate Body upheld the Panel’s interpretation of “benefit” as an advantage to the recipient in the market, and stated that “the marketplace provides an appropriate basis for comparison in determining whether a ‘benefit’ has been ‘conferred.’”¹¹⁸ Financial contributions distort trade, and a panel can identify this distortion by determining whether the industry received the financial contribution on “terms more favourable than those available to the recipient in the market.”¹¹⁹

In an efficient emissions trading market, installations have the incentive to invest in low carbon technology to avoid buying emissions allowances in the market.¹²⁰ However, when Germany allocates free emissions allowances, these incentives disappear because installations will not have to pay for allowances.¹²¹

117. See *id.* art. 1.1(a), (b), 1869 U.N.T.S. at 14 (mandating that a subsidy exists when a governmental measure involves a financial contribution and a “benefit is thereby conferred”).

118. *Canada-Civilian Aircraft*, *supra* note 87 ¶¶ 149–61 (emphasizing that the structure of Article 1.1 of the SCM Agreement is concerned with the benefit to the recipient and does not concern the cost to the government). The Appellate Body also contends that the marketplace provides an “appropriate basis” for calculating whether the measure made the recipient better off). *Id.*

119. *Id.* ¶ 157.

120. See OPERATOR’S GUIDE, *supra* note 1, at 3 (instructing that emissions trading schemes use a “market-based mechanism to incentivise” installations to reduce emissions in a “cost-effective and economically-efficient manner”). In addition, installations can buy allowances on the market, or they can sell any extra allowances they generated from reducing their emissions. *Id.* CAN EUROPE, *supra* note 67, at 27 (advancing the proposition that when governments require installations to pay for their emissions allowances, they provide the installations with the incentive to switch fuels, lower consumption, invest in better technology, and reduce energy demand); GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 9 (showing that the “possibility of selling unused allowances” provides installations with an incentive to invest in low carbon technology).

121. See GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 16 (emphasizing that the purpose of emissions trading is to place a “greater burden” on those installations with high carbon technology, and the “intended

Therefore, under Germany's NAP, installations receive allowances on terms more favorable than the terms they would otherwise receive in the market.¹²²

By allocating free emissions allowances, Germany also distorts the emissions market in such a way that allowances no longer reflect market value.¹²³ When emissions allowances no longer reflect market value, the German steel industry has an advantage over steel industries in other Member States.¹²⁴ The distribution methods that Germany used in its NAP are the main reasons that the emissions allowances do not reflect market value.¹²⁵

Under the grandfathering method of distribution, Germany based the allocation of allowances on the amount of greenhouse gases installations emitted in the past during a particular "base" period.¹²⁶ However, the E.U. Scheme leaves the crucial choice of assigning a base period to the Member States, which results in high gaming incentives and rent seeking by those that it affects.¹²⁷ Under the benchmarking method of distribution, Germany based the allocation of emissions allowances on the expected or potential output

outcome of [the] regulation" is to provide incentives to these installations to invest in low carbon technologies).

122. *See id.* at 3 (explaining that Member States should introduce emissions allowances as a new scarce resource, and this scarcity factor will drive the ultimate cost of emissions allowances in the market).

123. *See id.* (providing that an ideal emissions trading system allows market mechanisms to control the prices of the individual units, and all the government needs to do is create the proper conditions to allow trading to occur); *see also* Lohr, *supra* note 6 (suggesting that the most important step in combating climate change is setting a "real price on carbon emissions," which allows for greater efficiency in the short-run, and more investment in better technology and research in the long-run).

124. *See* Kurkowski, *supra* note 13, at 709 (predicting that inconsistent allocation methods may provide industries in one Member State with an advantage over industries in another Member State).

125. *See* GERMAN NAP, *supra* note 53, at 21 (explaining that the German government used historical emissions data and announced emissions to allocate its emissions allowances during Phase I of the E.U. Scheme, and it also applied "Special Rules" under certain circumstances).

126. *See* CAN EUROPE, *supra* note 67, at 24–25 (elaborating that Member States use this as their primary method of allocation, but because base years and the methods of calculation for emissions differ between the Member States, this method is problematic).

127. *See id.* at 25 (concluding that the grandfathering method of allocation has led to complaints about fairness between Member States).

quantities of a product.¹²⁸ However, calculating these amounts is extremely difficult and “fraught... with imperfections and potentially significant deviations from reality.”¹²⁹

Under both of the methods that Germany used, perpetuating the status quo by granting more allowances to installations that emitted a greater amount of emissions in the past was inevitable.¹³⁰ This results because when governments distribute emissions allowances free of charge, they base distribution on many factors that are not necessarily representative of market value.¹³¹ These factors include different types of pressures from interest groups or powerful industries with various political, social, or financial agendas.¹³²

In addition, Germany applies special rules, which are more lenient, to its steel industry.¹³³ Therefore, the steel installations have lower reduction obligations to meet in comparison to other industries.¹³⁴ Moreover, special rules cause installations to postpone investment in more energy-efficient technology.¹³⁵ These special rules result in the

128. *See id.* (noting that this method of allocation is favorable to the grandfathering method, especially for new entrants, because it does not require past emissions data to determine the allocation amount of emissions allowances). *But see* GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 4 (insisting that three conditions—preclusion of production distortions by installations for the purpose of maximizing allocations, security of long-term rights of use, and unrestricted tradability of allowances— must exist in order for the allocation process to be “effective and efficient” and to “give rise to the logical necessity for the allocation of allowances *not to be linked* to future output”).

129. CAN EUROPE, *supra* note 67, at 26.

130. *See id.* at 25 (warning that the benchmarking method of distribution can exaggerate the situation very easily in terms of carbon dioxide emissions when the government uses it improperly).

131. *See* Petsonk, *supra* note 65, at 207 (addressing the possibility that a government might allocate emissions allowances to further particular policies that it considers important).

132. *See* Kurkowski, *supra* note 13, at 711 (conceding that the discretion that Member States have in allocating emissions allowances results in huge incentives for different interest groups to invest in lobbying efforts to try to influence the allocation decisions where “billions of euros” are often at stake).

133. *See* GERMAN NAP, *supra* note 53, at 39 (enumerating the compliance factor for process-related emissions as one example).

134. *See* GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 12 (finding that the German government applied special rules to almost half of the emissions allowances that it allocated during Phase I of the E.U. Scheme).

135. *See id.* (theorizing that installations postpone investments to keep their options open and maximize their future allocations of emissions allowances).

grant of a greater number of allowances to inefficient installations, as opposed to those installations that adopt efficient technological measures to protect the environment.¹³⁶

The E.U. Scheme allows Member States to have discretion over how to allocate their emissions allowances between the industries and installations within their countries.¹³⁷ Germany uses this discretion to employ distribution methods and apply rules that result in allocations that distort the market system, benefiting its domestic steel industry.¹³⁸ Because Germany makes a financial contribution to the steel industry when it freely allocates emissions allowances, conferring a benefit to the steel industry, Germany's method of distribution could constitute a subsidy under the SCM Agreement.¹³⁹

B. GERMANY'S ALLOCATION OF FREE EMISSIONS ALLOWANCES
COULD BE EITHER AN ACTIONABLE SUBSIDY OR A NON-
ACTIONABLE SUBSIDY UNDER THE SCM AGREEMENT

The governmental measure at issue here is Germany's allocation of free emissions allowances (particularly to its steel industry) that Germany instituted pursuant to its NAP, which it enacted under the Directive.¹⁴⁰ A subsidy exists because the governmental measure at

136. See GERMAN NAP, *supra* note 53, at 29 (noting that the grandfathering process provides more favorable allowances to inefficient installations rather than to efficient ones, and highlighting the Council's efforts to counter this problem by permitting governments to credit early action measures by installations in the form of special allowances).

137. See Council Directive 2003/87, *supra* note 12, art. 9 (providing guidelines, rather than requirements, that Member States should follow when they devise their NAPs for each period to which Article 11(1) and (2) refers); see also Kurkowski, *supra* note 13, at 702, 708–09 (critiquing discretionary emissions allowance allocation on the grounds that equity concerns result if Member States are susceptible to the narrow interests of powerful industries, and that preferential treatment to favored industries burdens other industries, the taxpayers, and the non-trading sectors).

138. See GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 16 (concluding that the allocation of free emissions allowances has the effect of an "across-the-board subsidy not linked to output" and therefore results in windfall profits to the participating installations).

139. See SCM Agreement, *supra* note 17, art. 1.1, 1869 U.N.T.S. at 14.

140. See GERMAN NAP, *supra* note 53, at 39 (providing that process-related carbon-dioxide emissions will apply to the manufacture of oxygen and steel and in pig iron production therefore qualifying them for special rules allowances).

issue is a financial contribution that confers a benefit to the German steel industry. The SCM Agreement distinguishes between three types of subsidies.¹⁴¹ The allocation of free allowances is clearly not a prohibited subsidy because the practice is not contingent on “export performance,” nor is it contingent on “the use of domestic over imported goods.”¹⁴² However, a panel could find that the measure is either an actionable subsidy¹⁴³ or a non-actionable subsidy.¹⁴⁴

1. Germany’s Allocation of Free Emissions Allowances Could Be an Actionable Subsidy

A panel could find that the allocation of free emissions allowances by Germany is an actionable subsidy. Under the SCM Agreement, an actionable subsidy exists when a governmental measure is specific¹⁴⁵ and causes “adverse effects to the interests”¹⁴⁶ of other Member Countries. These effects include: “an injury to the domestic industry of another Member; nullification or impairment of benefits...;”¹⁴⁷ or serious prejudice¹⁴⁸ to the interests of another Member.”¹⁴⁹

141. See SCM Agreement, *supra* note 83, arts. 3, 5, 8, 1869 U.N.T.S. at 16, 18, 23–25.

142. See *id.* art. 3, 1869 U.N.T.S. at 16.

143. See *id.* art. 5, 1869 U.N.T.S. at 18 (defining an actionable subsidy as a measure that causes “adverse effects to the interests of other Members, i.e.: (a) injury to the domestic industry of another Member; (b) nullification or impairment of benefits accruing directly or indirectly. . .; (c) serious prejudice to the interests of another Member”).

144. See *id.* art. 8.1, 1869 U.N.T.S. at 22 (defining non-actionable subsidies as those that fail the specificity test of Article 2, or satisfy one of its exceptions); *id.* art. 9.1, 1869 U.N.T.S. at 25 (limiting the scope of non-actionable subsidies to situations in which the subsidies cause “serious adverse effects” to the domestic industry of another Member Country).

145. See *id.* art. 1.2, 1869 U.N.T.S. at 14 (subjecting a subsidy to the provision of Part III, which elaborates on actionable subsidies, only if the subsidy meets the specificity requirements articulated in Article 2).

146. *Id.* art. 5, 1869 U.N.T.S. at 18.

147. See *id.* art. 5(b), 1869 U.N.T.S. at 18 (elaborating that the nullification or impairment of benefits accruing could be either direct or indirect, and referring in particular the benefits of GATT 1994 Article II concessions); see, e.g., USTR STATEMENT, *supra* note 89 (stating that an instance of nullification or impairment occurs when a subsidy negates the value of a tariff cut).

148. See SCM Agreement, *supra* note 17, art. 6, 1869 U.N.T.S. at 18–20 (defining a serious prejudice to exist when: the “total ad valorem subsidization of a product” exceeds five percent; the subsidies cover operating losses that an industry has to endure; the subsidies cover operating losses other than “one-time measures”

In order for a panel to hold that a governmental measure is an actionable subsidy, the measure must meet the specificity requirement set forth in Article 2 of the SCM Agreement.¹⁵⁰ The allocation of free allowances meets this specificity requirement because Germany “explicitly limits access” of the emissions allowances to the industries that the Directive includes in the E.U. Scheme.¹⁵¹ The NAP explains that other measures and policies govern those industries that the Directive does not include in the E.U. Scheme, such as the transport and household sectors.¹⁵² Therefore, since the Directive explicitly limits the NAP to certain industries,¹⁵³ it meets the specificity requirement.

When Germany allocates all of its emissions allowances free of charge to its steel industry, it could cause adverse effects to the steel industry of another Member State. Germany’s measure could potentially injure the steel industry of another Member State that does not receive its emissions allowances free of charge, but through another method of allocation, such as the auction method.¹⁵⁴ The

that are “given merely to provide time for the development of long-term solutions” and to avoid short-term social problems; or “the direct forgiveness of debt” that an installation owes to the government); *see also* USTR STATEMENT, *supra* note 89 (explaining that a panel will base the determination of serious prejudice on measurable and verifiable data).

149. *See* SCM Agreement, *supra* note 17, art. 5, 1869 U.N.T.S. at 18 (prohibiting Members from enacting a subsidy, as defined in Article 1, that causes adverse effects to the interests of other Members).

150. *Id.* art. 1.2, 1869 U.N.T.S. at 14.

151. *Id.* art. 2.1(a), 1869 U.N.T.S. at 15.

152. *See id.* *See* GERMAN NAP, *supra* note 53, at 20 (listing some of the most successful measures and policies for climate protection in the transport sector as “ecological tax reform,” “promotion of renewable energy sources for fuels,” and a “campaign to encourage a climate-conscious attitude in transport”). Some of the most successful measures in the household sector include a carbon dioxide reduction program, a carbon dioxide building redevelopment program, and a housing modernization program. *Id.*

153. *See id.* at 7 (pointing out that the installations that the NAP covers for emissions trading, for the most part, comprise the energy and industrial sectors).

154. *See* Petsonk, *supra* note 65, at 207 (characterizing the auction method as one in which a country sells either a portion or all of its emissions allowances to the installations that can afford to bid the highest for them); *see also* CAN EUROPE, *supra* note 67, at 28 (explaining that only four Member States have used the auction method, but none of them have used it extensively).

foreign steel industry would have a higher regulatory burden to meet because it would have to pay for its emissions allowances.¹⁵⁵

Germany could also seriously prejudice the interests of another Member State by covering the operating losses its own steel industry would have to endure,¹⁵⁶ while other Member States might not grant their industries the same luxury. The subsidy could have the effect of a significant undercutting of the price of steel in Germany as opposed to the other Member States.¹⁵⁷ Germany would have the burden of demonstrating that serious prejudice to the interests of other Member States does not result from its method of allocation.¹⁵⁸

2. Germany's Allocation of Free Emissions Allowances Could Be a Non-Actionable Subsidy

A panel could find that the allocation of emissions allowances free of charge by Germany is a non-actionable subsidy if the measure meets the criteria laid out in Article 8 of the SCM Agreement.¹⁵⁹ A subsidy that meets the non-actionable criteria does not invoke consultations and remedies unless the "Member has reason to believe that [the action] has resulted in serious adverse effects to the domestic industry of that Member."¹⁶⁰ However, Member States may

155. See Kurkowski, *supra* note 13, at 702, 709 (hypothesizing that differing allocation methods between Member States could give an industry in one Member State a competitive advantage over an industry in another Member State).

156. See SCM Agreement, *supra* note 17, art. 6.1(b), 6.1(c), 1869 U.N.T.S. at 18 (identifying measures that the government enacts to cover operating losses as an act seriously prejudicial to the interests of another Member State).

157. See *generally id.* art. 6.3, 1869 U.N.T.S. at 19 (giving various instances in which serious prejudice may arise including instances where the subsidy significantly undercuts the price of the subsidized product).

158. See USTR STATEMENT, *supra* note 89 (explaining that if a subsidy falls within any of the four categories listed in Article 6.1 of the SCM Agreement, a WTO panel will presume serious prejudice, and will place the burden on the subsidizing government to prove that serious prejudice did not result from its actions).

159. See SCM Agreement, *supra* note 17, art. 8, 1869 U.N.T.S. at 22–25 (elaborating that subsidies are non-actionable if they are not specific, or if they are specific and fall into one of the three categories set forth in Article 8.2: government assistance for certain research activities; assistance to disadvantaged regions for development; or assistance to promote adaptation of facilities to new environmental requirements).

160. See *id.* art. 9, 1869 U.N.T.S. at 25 (providing circumstances under which Member Countries can invoke consultations and remedies for non-actionable

request consultations and authorized remedies for these types of subsidies if they cause “serious adverse effects” to their domestic industry and the damage that the subsidies cause is “difficult to repair.”¹⁶¹

The German government likely would argue that although the allocation of free allowances is not a subsidy, if a panel did find that the measure was a subsidy, it would be non-actionable because it meets the criteria laid out in Article 8.2(c) of the SCM Agreement regarding assistance for environmental regulations.¹⁶² The government would argue that the measure constitutes government “assistance to promote adaptation of existing facilities” to “new environmental requirements.”¹⁶³ The German government would then argue that the Directive laid out new requirements that installations had to meet,¹⁶⁴ and by freely allocating allowances, Germany simply was aiding installations as it adjusted to the new requirements.

While the German NAP allowed for the allocation of free emissions allowances in Phase I of E.U. Scheme,¹⁶⁵ it also allows for the allocation of free allowances in Phase II.¹⁶⁶ The measure at issue, therefore, does not meet the first condition: that the assistance must be a “one-time non-recurring measure.”¹⁶⁷ Moreover, within each

subsidies).

161. *Id.* art. 9.1, 1869 U.N.T.S. at 25; see USTR STATEMENT, *supra* note 89 (explaining that the standard of “serious adverse effects” that non-actionable subsidies must meet is a much higher standard than the “serious prejudice” or “injury” standard for other subsidies).

162. See SCM Agreement, *supra* note 17, art. 8.2(c), 1869 U.N.T.S. at 24 (including assistance to promote the adaptation of existing facilities to environmental regulations in the category of non-actionable subsidies).

163. *Id.*

164. See Council Directive 2003/87, *supra* note 12, art. 1 (mandating that installations reduce greenhouse gas emissions and establishing a scheme to facilitate carbon dioxide emissions trading between the Member States).

165. GERMAN NAP, *supra* note 53, at 4.

166. *Id.* at 21.

167. See SCM Agreement, *supra* note 17, art. 8.2(c), 1869 U.N.T.S. at 24 (explaining that although the environmental regulations would result in “greater constraints and financial burden” on the installations, the assistance is only non-actionable if it is a “one-time non-recurring measure” and meets the four other criteria listed in 8.2(c)).

Phase, Germany issues the allowances in annual distributions.¹⁶⁸ Thus, the measure is recurring.

Nevertheless, even if Germany convinced a panel that it met all the criteria for a non-actionable environmental subsidy, the panel may still recommend that it remove the measure.¹⁶⁹ A Member State could challenge the measure because it caused “serious adverse effects”¹⁷⁰ to its steel industry that were too “difficult to repair.”¹⁷¹ If a Subsidies Committee agreed, then Germany would have to remove the measure within six months.¹⁷²

IV. RECOMMENDATIONS

The European Union cannot accomplish the lofty objective of the E.U. Scheme if its Member States distribute emissions allowances free of charge. The E.U. Scheme can operate at its most efficient level and achieve emissions reductions at the lowest possible cost and in the most effective manner possible¹⁷³ only if Member States distribute allowances under the auction method.¹⁷⁴ The Council should amend the Directive in the following two key ways to prepare for Phase II of the E.U. Scheme.

168. See GERMAN NAP, *supra* note 53, at 4 (detailing that Germany will issue the emissions allowances yearly by February 28 “of the year in question”).

169. See SCM Agreement, *supra* note 17, art. 9.4, 1869 U.N.T.S. at 25 (noting that if a Committee concludes that serious adverse effects exist, it may recommend that the subsidizing Member Country modify its measure to remove the effects). If the Member Country does not modify its measure, the Committee can authorize the “requesting Member to take appropriate countermeasures.” *Id.*

170. *Id.* art. 9.1, 1869 U.N.T.S. at 25.

171. *Id.*

172. See USTR STATEMENT, *supra* note 89 (explaining that two Member Countries can determine through consultations whether a subsidy caused serious adverse effects, and if these consultations are unsuccessful, then a Subsidies Committee has 120 days to determine whether the measure meets the higher serious adverse effects standard). In addition, if a Committee does find serious adverse effects, the subsidizing Member Country has six months to remove them, or the Committee can authorize the complaining Member Country to take proportional countermeasures. *Id.*

173. See Kurkowski, *supra* note 13, at 700 (affirming that the current design of the method of allocation in the E.U. Scheme results in efficiency concerns relating to the proper functioning of the market to achieve the environmental goals that the Directive envisioned and equity concerns relating to the redistribution of wealth).

174. CAN EUROPE, *supra* note 67, at 27.

First, the Council should ensure that Member States impose a minimum level of scarcity on the amount of emissions allowances they establish in their Macroplans by providing a uniform formula to calculate this level. Second, the Council should give Member States strict guidelines regarding the methods of distribution that they include in their Microplans. Further, the Council should not hesitate to reject NAPs that do not conform to the criteria that it establishes.¹⁷⁵

A. THE COUNCIL SHOULD AMEND THE DIRECTIVE TO ENSURE THAT MEMBER STATES IMPOSE A UNIFORM MINIMUM LEVEL OF SCARCITY

The E.U. Scheme allows installations to make higher profits from low carbon technologies and provides incentives for installations to invest in those technologies.¹⁷⁶ Those in favor of allocations of free allowances argue that a free “needs-based” allocation process is necessary to secure the German industries’ competitive position.¹⁷⁷ However, installations within an industry gain a competitive edge when they engage in activities that allow them to use less of their emissions allowances, so the allocation of free allowances has no impact on competitiveness.¹⁷⁸ Therefore, Member States should integrate emissions allowances into industries as a new scarce resource, so that the scarcity factor will control the market value of emissions allowances.¹⁷⁹ Otherwise, without a sufficient degree of

175. *See id.* art. 9 (allowing the Council to reject a Member State’s NAP within three months of its submission if it does not meet the criteria set forth in Article 10 and Annex III of the Directive); *see also* Watchman, *supra* note 57, at 201 (elaborating that the Council reduced the amount of emissions that Member States planned to allocate in their initial NAP submissions by four percent). Furthermore, the Council rejected thirteen NAPs for allowing adjustments to the amount of allowances that they allocated to installations. *Id.*

176. *See* GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 2 (demonstrating that the E.U. Scheme’s regulatory provisions do not inhibit an industry’s competitive edge).

177. *See id.* (arguing the paradoxical nature of the argument because capping emissions is inherent in the success of an emissions trading system, and by basing allocation on needs, the Member States would no longer be able to attain the objective of capping emissions).

178. *See id.* (observing that “changes in competitiveness” arise from the scarcity of emissions allowances).

179. *See id.* at 3 (explaining that because carbon dioxide emissions effectively

scarcity, installations would have no need to buy or sell emissions allowances.¹⁸⁰

As it currently stands, the Directive does not give the Council any legal basis for imposing a specific minimum level of scarcity on the allocation of emissions allowances.¹⁸¹ The Council should devise a central formula that Member States must use to calculate the total amount of emissions allowances they will allocate during Phase II. By doing so the Council will ensure that the price of the emissions reflects market values.

Since Annex III of the Directive gives Member States criteria to follow when they devise their NAPs,¹⁸² within this Annex, the Council should calculate the most efficient formula to achieve the optimal minimum level of scarcity for the quantity of emissions allowances that Member States should include in their Macroplans for Phase II.¹⁸³ The Council should mandate that Member States use this formula when they calculate their emissions budgets. If need be, it should update the formula during subsequent phases to adapt to future conditions.

B. THE COUNCIL SHOULD AMEND THE DIRECTIVE TO ENSURE
THAT THE MEMBER STATES USE CONSISTENT METHODS OF
DISTRIBUTION

The Council devised the E.U. Scheme in a way that gave Member States too much discretion when they develop their NAPs. This discretion allows Member States to use distribution methods that do not result in the most efficient allocation of emissions allowances. The Council should mandate that every Member State use the same methods of allocating allowances for every installation. By doing so, it will ensure that social factors, political factors, or powerful interest

become traded goods, installations must take their costs into account when planning optimal production quantities, and therefore, they represent a new constraint to those operating installations).

180. See Kurkowski, *supra* note 13, at 708 (stressing that with insufficient scarcity, Phase I of the E.U. Scheme “would serve no practical purpose”).

181. See *id.*

182. See Council Directive 2003/87, *supra* note 12, Annex III.

183. See GERMAN NAP, *supra* note 53, at 6 (explaining that Macroplans define the total emissions budget of Member States and include the total quantity of emissions allowances that a Member State can allocate).

groups do not bias the Member States' governments when they devise their Microplans.¹⁸⁴ This will result in a fairer allocation of emissions allowances to industries between the Member States.

First, the Council should eliminate the use of special rules that Member States can apply under certain circumstances.¹⁸⁵ Next, the Council should amend Article 10 of the Directive, which mandates that Member States distribute at least ninety percent of emissions allowances free of charge during Phase II.¹⁸⁶ As Part III above demonstrates, when Member States allocate emissions allowances free of charge, they become vulnerable to subsidy claims under the SCM Agreement.¹⁸⁷ The Council should allow for a gradual transition into a system that mandates that installations bid for one-hundred percent of their emissions allowances.¹⁸⁸ Thus, during Phase II, the Council should mandate that each Member State shall allocate seventy-five percent of emissions allowances free of charge.¹⁸⁹

Member States should allocate the same number of allowances free of charge to avoid unfairness between the countries and possible subsidy claims.¹⁹⁰ In addition, Article 10 should include a separate paragraph stating which distribution methods each Member State should employ:

184. See Kurkowski, *supra* note 13, at 702 (noting that the influence of powerful interest groups can make state regulators vulnerable and can bias them to favor certain installations when they make their allocation decisions).

185. See GERMAN ADVISORY COUNCIL ON THE ENVIRONMENT, *supra* note 13, at 12 (opining that the special rules foster uncertainty and strategic behavior and as a result, installations postpone investment in low carbon technology).

186. Council Directive 2003/87, *supra* note 12, art. 10.

187. See *supra* Part III.A–B (analyzing that a panel could conclude that the allocation of free emissions allowances by Germany is a subsidy, and it could be either actionable or non-actionable). If the subsidy is non-actionable, Germany may still have to modify the measures to remove serious adverse effects to other Member States. See *id.* Part III.B.2.

188. See CAN EUROPE, *supra* note 67, at 27 (explaining that the only way that governments can implement the “polluter pays principle” in the E.U. Scheme is by using the auction method of distribution and mandating that installations pay for all of their emissions allowances).

189. See Council Directive 2003/87, *supra* note 12, art. 10 (allowing a less stringent method of allocation by stating “Member States shall allocate at least ninety percent of the allowances free of charge”) (emphasis added).

190. See *supra* Part III.A (analyzing how subsidies can arise when some countries allow the allocation of free emissions allowances, and others do not).

Each Member State must allocate allowances for the five-year period beginning 1 January 2008 using the same distribution methods. For each industry, twenty-five percent of the allowances must be auctioned to the highest bidder, twenty-five percent of the allowances must be granted free of charge using the grandfathering method of distribution, and fifty percent of the allowances must be granted free of charge using the benchmarking method of distribution.

Consistency in allocation methods between Member States will ensure fairness. Therefore, the Council should not allow Member States to auction more or less than twenty-five percent of allowances for Phase II.¹⁹¹ However, during subsequent phases of the E.U. Scheme, the Council should mandate that Member States distribute one-hundred percent of the emissions allowances through the auction method.¹⁹² By ensuring that the allocation methodologies between the Member States are consistent and harmonized,¹⁹³ the Council will guarantee that a fair allocation of emissions allowances results and will avoid possible subsidy claims between Member States.

Throughout the review and approval process, the Council should take advantage of its oversight power over the NAPs, and should reject those that do not conform.¹⁹⁴ Although the Council has the

191. See *supra* Part III.A–B (demonstrating that even though the auction method is the most efficient, when Member States use inconsistent methods of allocation, this could result in possible subsidy claims).

192. See Council Directive 2003/87, *supra* note 12, art. 30(c) (acknowledging the need to harmonize the methods of distribution between the Member States during subsequent phases of the E.U. Scheme); see also CAN EUROPE, *supra* note 67, at 27 (reaffirming the Council’s consideration, which it articulated in Article 30, and recommending that Member States increase the use of the auction method during future phases). In addition, the auction method is preferable to the grandfathering and benchmark methods because it generates revenue that the government can use to spend on research and development for more fuel-efficient technologies. *Id.*

193. See Kurkowski, *supra* note 13, at 728 (arguing that a fair allocation of emissions allowances that has minimal negative distributional consequences results from a “consistent methodology or allocation formula” across the Member States of the European Union).

194. See Council Directive 2003/87, *supra* note 12, art. 9. *But see* Kurkowski, *supra* note 13, at 709–10 (arguing that the E.U. Scheme should allow Member States to have some flexibility when they devise their NAPs). One should weigh any distributional consequences against state sovereignty concerns, and the fact that each Member State is probably in the best position to determine how many

authorization to amend the Directive,¹⁹⁵ if it chooses not to amend it, however, the Member States should, and can, do so by a majority vote.¹⁹⁶ By amending the Directive, the Member States will ensure that the European Union meets the goals and objectives of the Directive,¹⁹⁷ not only at the lowest possible cost, but also through the most effective means possible.

V. CONCLUSION

Even though the E.U. Scheme is a good model for emissions trading in the international arena and meeting commitments under the Kyoto Protocol, as the German NAP demonstrates, the E.U. Scheme is still not perfect. The Council can, and should, amend the E.U. Scheme to eliminate possible subsidy claims between Member States. By imposing a uniform formula for Member States to calculate allowance caps to ensure scarcity, and by harmonizing allocation methods between the Member States, the European Union will be able to attain emissions reductions in the most cost-effective and equitable manner possible.

emissions allowances each industry and its various installations should receive. *Id.*

195. See *supra* Part IV.A–B (recommending the ways in which the Council should amend the Directive).

196. See Kurkowski, *supra* note 13, at 729 (explaining that while the Council can amend the Directive, it “has indicated that it does not intend to do so”).

197. See Council Directive 2003/87, *supra* note 12, ¶ 5 (stating that the goal of the Directive is to help Member States achieve their reduction commitments under the Kyoto Protocol “through an efficient European market in greenhouse gas emission allowances, with the least possible diminution of economic development and employment”).