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The making of Emissions Trading laws – understanding the EU legislative process

Introduction Unlike most traded commodity markets, the market for trading carbon credits or emissions allowances in the EU is not one based on its utility, usage or consumption. A carbon credit is not used in manufacturing processes or consumed like power or grain. Its market is entirely an invention of policy as implemented through legislation and regulation with a view to reducing the carbon emissions in the EU. Any demand for a carbon credit or emission allowance (“**allowances**”), is also therefore a creation of those legislative and regulatory processes. That process has left the EU Emissions Trading Scheme (“**EU ETS**”), today in its third phase,¹ moribund with an over-supply of allowances.²

Although the EU ETS is a relatively new market, it has certainly had its share of teething problems. Some of these problems (e.g. VAT fraud and addressing security aspects from carbon registry hacking incidents) have been through a lack of foresight on the part of the European Commission (the “**Commission**”) and the member states. Others, such as the over-supply problem, have been as a result of a combination of fewer allowances required through financial crisis-induced lower industrial output, and the lack of ambition on the part of the developed world (including the member states) to take on more stringent caps for its emissions output. In the case of each of these problems, the Commission’s response has been to propose more legislation to tweak, amend or revise its original legislation. We have seen three versions of a ‘new’ Registry Regulation³ between 2009 and 2011, and have just had a fourth new version in May 2013. As the Commission proposes various ‘fixes’ or applies band-aids to the various problems it has to address, it sometimes builds on bad policy with more bad policy. The inclusion of the aviation sector within the EU ETS and the subsequent ‘temporary’ exclusion for one year only, springs to mind as a good example of the Commission’s “band-aid” approach to legislative intervention. “Two wrongs don’t make a right” seems an apt description of much of the legislation recently introduced, including some

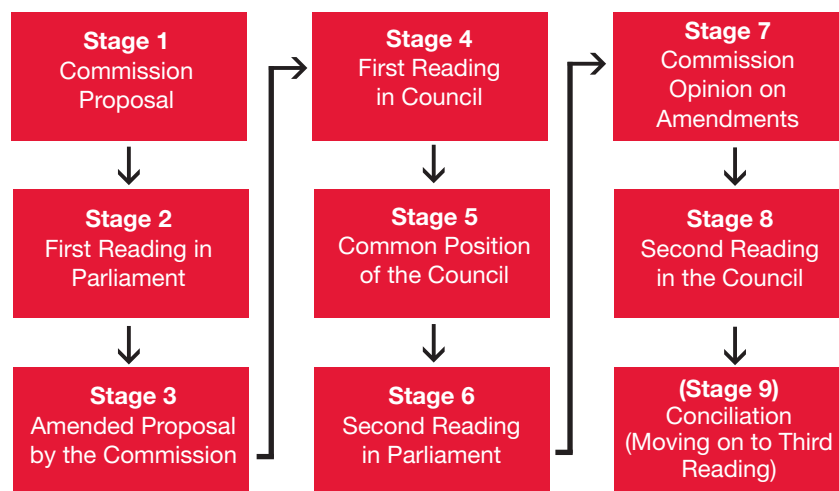
that has been designed to have retrospective effect.

Therefore, how does a participant in the carbon market manage risk and uncertainty arising from a volatile and unpredictable legislative process? Unlike any other market, in the EU ETS it becomes essential to understand the legislative process as part of the toolkit of risk management, used by risk managers looking after traders. The importance of understanding the legislative process and the price volatility that can be triggered from a knee-jerk reaction to minor steps in the legislative process, was most visibly seen in the Commission’s recent proposal known as the ‘Backloading’ proposal.⁴ We will use the ‘Backloading’ proposal as an example to illustrate the legislative process followed in the EU ETS. This client alert seeks to demystify the labyrinth that is the EU rule making process in the EU ETS.⁵

The Codecision Procedure The most commonly used procedure for making law in the EU is the codecision procedure.⁶ In the last legislative term (2004-2009) a total of 447 codecision files were concluded. The first half of the seventh parliamentary term (2009-2011), confirms the trend of first reading agreements: 136 codecision files (78%) were concluded at first reading, 32 (18%) at second reading and 7 (4%) at third reading. With the considerable extension of the scope of the procedure under the Treaty of Lisbon, the number of codecision files is expected to increase in the future.⁷

Diagram 1 (below) provides a high-level overview of the codecision procedure (a more comprehensive flow diagram has been included at Appendix 1). The majority of EU legislation will not require that the full nine stages of the process be utilised. If the proposed legislation is well supported by the EU Parliament and the Council of the European Union then it is possible that that it will become law after having completed only stages one to five.

Diagram 1



Stage 1: The Commission Proposal The Commission has the right of initiative under the codecision procedure.⁸ The European Parliament (the “**Parliament**”)

and the Council of the European Union (the “**Council**”) then examine the proposals and suggest amendments before voting on whether the law should pass. Although there are several ways in which the Parliament and the Council can examine laws, the most common method is the codecision procedure. The Commission will place its proposal before the Parliament and the Council simultaneously.

Stage 2: First Reading in the Parliament The European Parliament delivers an opinion at first reading.

This opinion is prepared at two levels:

- At parliamentary committee level
- At plenary level

Parliamentary Committee When the Commission text reaches the Parliament, the parliamentary committee responsible (the “**lead committee**”), is named along with any other committees that are asked for non-binding opinions. Within the lead committee, the political groups’ coordinators designate a rapporteur entrusted with the drafting of the report containing the proposed amendments, if any, put forward by the Parliament. The parliamentary committees meet several times to study the draft report prepared by the rapporteur, as well as amendments put forward by other MEPs. These parliamentary amendments, as well as those suggested by the individual committee, are put to the vote in the lead committee, on the basis of a simple majority. Only the lead committee⁹ will have a binding vote, and a simple majority is needed to approve the report before the Commission’s proposal can progress.

During the equivalent committee process of the “Backloading” proposal, EU carbon prices slid 40%¹⁰ after the Industry, Research and Energy Committee (ITRE) opposed plans to support the proposal (in January), even though the ITRE’s role was only advisory and the vote was non-binding. This perhaps suggested an overreaction by the market or a limited understanding of the EU legislative process, or perhaps, a little of both. The lead committee¹¹ subsequently voted in favour of the proposal with a stronger-than-expected margin.¹²

Adoption in Plenary Once the report is adopted at committee level, it then goes to plenary, as both the “Backloading” and “Stop-the-clock”¹³ proposals did on 16 April 2013. Additional amendments to the report, including amendments adopted in the parliamentary committee, may be tabled by political groups and put to the plenary’s vote. Ahead of the vote, the rapporteurs and shadow rapporteurs present their report, followed by the relevant Commissioner.¹⁴

In the first reading, following the opinions at the committee and plenary levels, a simple majority (i.e., majority of MEPs present during the vote) is required to adopt the amendments, either on an amendment-per-amendment basis or “en bloc.”

First Reading in the Parliament – Examples of Process

In focus:
“Backloading” Proposal
 Rejected by a narrow margin
 334 in favour
 315 voting against
 63 abstaining

“Backloading” Proposal The “Backloading” proposal, as referred to in the media, conjoins two separate stages; only the first stage was subject to a plenary vote on 16 April 2013. The first stage, to amend the EU ETS Directive, did not receive the simple majority needed to take it to stage 4 of the legislative process. This has derailed the Commission’s stage 2 plans to implement the amendment to the “Auctioning Regulation.”¹⁵

With the rejection of the Commission’s proposal, the Commission could choose to maintain the proposal by going back to the lead committee for amendment to try and gain a position of support at committee level. Recent reports suggest that this will happen, perhaps following the German government’s support for the proposal. The Commission has not formally withdrawn its proposal, as it took the confusion caused during the voting process¹⁶ on 16 April to conclude that the proposal may not be “dead in the water.” When introduced the Backloading Proposal will start from stage 2 above.

In focus:
“Stop-the-clock” proposal
 Support by a large margin
 577 in favour
 114 voting against
 21 abstaining

“Stop-the-clock” Proposal In contrast, during the same parliamentary session the Parliament voted in favour of and adopted the ‘Stop-the-clock’ proposal. The result of the plenary vote is already being negotiated with the Council (see stage 4 below) and majority support and adoption by the Council without amendment seems very likely.

Stage 4: First Reading of the Council The Council examines the Commission’s initial proposal in parallel to the Parliament. This work is conducted within specific working parties, made up of representatives of the member states and chaired by the representative of the member state holding the presidency. The Commission attends these meetings and can provide expert advice. The Council, however, only finalises its position once it has sight of the Parliament’s first reading amendments and the Commission’s resulting amended proposal.

If the Parliament has not adopted any amendments to the Commission’s proposal and the Council accepts the Commission’s proposal without alteration, the act will move on for its second reading in the Parliament.

Even if the Parliament has introduced amendments, if they are uncontroversial then the Council can choose to approve the amendments by qualified majority (see Diagram 2) and just as in the scenario set out above, the outcome is an early first-reading agreement.

Diagram 2

Qualified Majority Voting (after the Lisbon Treaty)

A decision requires at least 255 out of 345 votes to be adopted

France, Germany, Italy, the Uk	29 each
Spain, Poland	27 each
Romania.....	14
Belgium, Czech Republic, Greece, Hungary, Portugal	12 each
Austria, Bulgaria, Sweden	10 each
Denmark, Finland, Ireland, Lithuania, Slovakia	7 each
Cyprus, Estonia, Latvia, Luxembourg, Slovenia	4 each
Malta	3
TOTAL	345

However, not all legislative proposals have a smooth ride through the codecision procedure, especially if they have been passed by only a narrow margin in the Parliament’s plenary vote. If the Council wishes to make amends to the adopted Parliament text, two sub-options are possible and are explored more fully in Appendix 1: a second reading will only be required if the Council position is not in line with the Commission’s amended proposal, then unanimity will be required to adopt its Common Position. The Council may amend the Commission proposal only by acting unanimously (except in Conciliation). However, in order to facilitate the Council’s vote with qualified majority, the Commission often amends its original proposal just before the adoption of the Council’s Common Position.¹⁷

During the whole first reading stage, neither the Parliament nor the Council are subject to any time limit by which they must conclude their first reading.

Stage 5: Communication of the Common Position The next stage is a Commission communication on the Council Common Position, which is forwarded to the Parliament in tandem with the Council Common Position, and explains why the Commission has decided to support or oppose the Council Common Position. The Commission also comments on the Council’s reaction to Parliament’s

amendments which it had supported in plenary at the first reading.

Informal Trialogues

When the co-legislators are seeking to conclude an agreement at first reading, it is often the case that they organise informal tripartite meetings attended by representatives of the Parliament (rapporteur and, where appropriate, shadow rapporteurs), the Council (chair of the working party), and the Commission (department responsible for the dossier and the Commission’s Secretariat-General).

Stage 6: Second Reading in the Parliament A three-month time limit¹⁸ is imposed for the Parliament to take action on the basis of the Council Common Position. After the three month

period to allow for scrutiny, provided there have been no objections passed, the legislative act can then be then submitted directly for the signature of the Presidents and Secretaries-General of the Parliament and of the Council, and is published in the Official Journal, ending the procedure.

It is likely that the “Stop-the-clock” proposal, first proposed on 20 November 2012 and passing its first Parliamentary plenary vote on 16 April 2013 will move forward without amendment and become law by July 2013.

However, as demonstrated by the “Backloading” proposal, not all proposed legislation will follow stages one to five of the codecision procedure without challenge. If the Parliament suggests amendments to the Council position at first reading then the proposed legislation will move on to stages six to nine of the codecision procedure (See Diagram 1).

Final Stages (stages 7 to 9): Second Reading by the Council, Commission Opinion, Conciliation Procedure and Third Reading The Council has a further three months¹⁹ to approve the Parliament’s second reading text. The adoption procedure is broadly similar to that at first reading, but with substantial restrictions on the nature of the amendments that can be tabled at second reading.²⁰ The plenary will make its position known on the basis of the amendments included in the recommendation adopted by the parliamentary committee and any amendments tabled in plenary by political groups. The plenary will then need to adopt amendments by absolute majority.²¹

If the Council, voting by a qualified majority on the Parliament’s amendments (see Diagram 2), and unanimously on those which have obtained the Commission’s negative opinion, approves all of the Parliament’s amendments no later than three months after receiving them, the act is deemed adopted.

In all other cases, Conciliation must be initiated, the Conciliation Committee having to be convened within six weeks.²² Conciliation is rare in practice (see Appendix 1).

Distinguishing Codecision from Comitology An important distinction must be drawn between when the codecision procedure is used to create new laws, exemplified by the “Stop-the-clock” and “Backloading” proposals, and when there is delegation to the process of “comitology”. Comitology is an example of EU implementing procedure, used when legislation has already been passed by codecision but requires further amendment to be fully implemented, exemplified by the new “Registry Regulation.”²³

The “comitology” procedure applies to the adoption of measures of general scope designed to apply essential provisions of basic instruments, or if specified, to adapt, delete or amend certain non-essential provisions of that basic instrument. The Comitology Regulation²⁴ sets out uniform conditions for the implementation

of legally binding European Union acts, those acts (“**basic acts**”) are to confer implementing powers on the Commission.

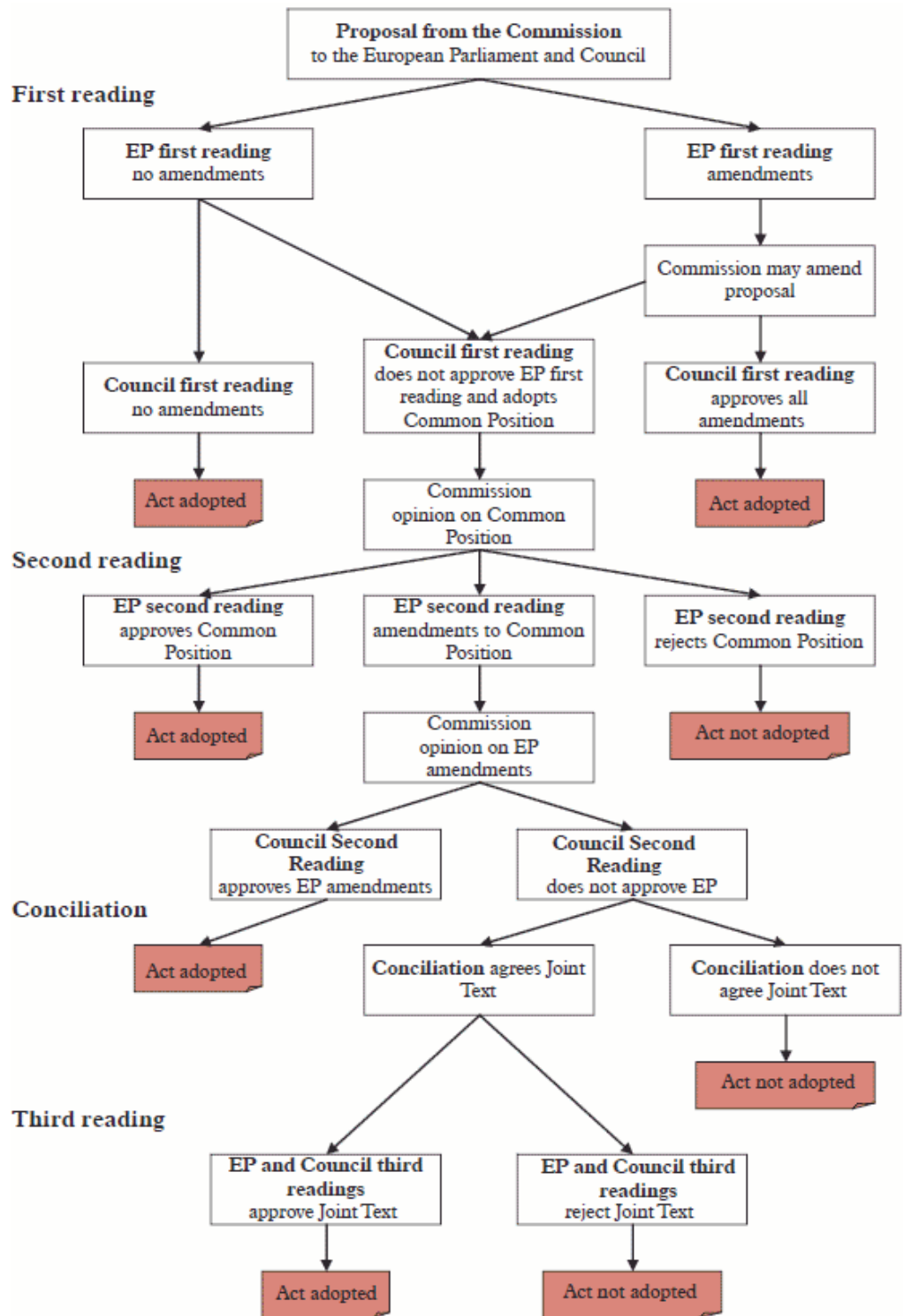
It is for the legislator, in accordance with the criteria laid down in the TFEU,²⁵ to decide in respect of each basic act, whether to confer implementing powers on the Commission. A basic act may provide for the application of the advisory procedure or the examination procedure, taking into account the nature or the impact of the implementing act required. The new Registry Regulation is an example of the examination procedure. The latest incarnation of the Registry Regulation was put to vote in the EU Climate Change Committee (the relevant committee) on 24 January 2013, and it received a majority vote in favour. It was then forwarded by the Commission to both the Council and the Parliament, which have up to three months to oppose the measure. The measure was adopted, after the three-month period lapsed, on 2 May 2013.²⁶

Conclusion The lessons learnt by the participants in the EU ETS are mostly through hard and often painful experience. Price volatility has often been extreme and, as a commodity to invest in, allowances have often not provided a risk-worthy return. In a market created by legislation, an understanding of how the EU goes about making the laws, regulations and rules that allow the EU ETS to exist and operate is therefore key to the market’s ability to attract investment in low-carbon abatement technology, and in altering the behaviour of large emitters.

As a policy measure, the concept of cap-and-trade as the best tool to achieve a price on our carbon emissions is being challenged in the EU, at a time when other countries (e.g., Australian, South Korea and Kazakhstan) and regional schemes (e.g., California and Quebec) are adopting their own cap-and-trade schemes. The EU ETS, as the oldest and largest international scheme, has an important climate leadership role to play and its trials and tribulations will be lessons to others.

For risk managers, a better appreciation of the significance of the price volatility driven by EU ETS legislative and regulatory activism will enable them to do their jobs more effectively. The problem for the market is that there are no market tools to hedge against the unpredictability of the legislator, although the effectiveness of lobbying as a tool in the EU legislative process, as seen in the “Backloading” proposal, appears to be increasing.

Appendix 1
The Codecision Procedure—flowchart



<http://www.publications.parliament.uk/pa/ld200809/ldselect/ldcom/125/12504.htm#a2>

1. The EU ETS's third phase commenced 1 January 2013, and will run until 31 December 2020.
2. On aggregate, the EU ETS in Phase III is forecasted to remain significantly oversupplied until after 2020, with the peak predicted to be reached around 1500-2000 Mt in 2015-2016, followed by a decline to 1000-1500 Mt by 2020. Source: IETA briefing on the EU's Emissions Trading Scheme www.ieta.org/assets/EUWG/ieta_briefing_euets10042012.pdf.
3. Commission Regulation (EC) No. 406/2009, Commission Regulation (EU) No. 920/2010 and Commission Regulation (EU) No. 1193/2011.
4. This proposal was to amend Directive 2003/87/EC (the "**EU ETS Directive**") to clarify the timing of auctions that may be carried out in the EU ETS and therefore, to empower the Commission to then amend Commission Regulation (EU) No. 1031/2010 (as amended, the "**Auction Regulation**"). The Commission would thereby, instead of an even distribution of auctioned allowances throughout the third phase, create an artificial scarcity in the first three years of the phase by reducing the available allowances for auction and skew the availability near the end of the phase by increasing the numbers auctioned in 2018 and 2019.
5. This note does not seek to be a comprehensive guide on all the EU processes available for making laws but only those that are most commonly used in the context of the carbon markets.
6. The codecision procedure itself is a framework for negotiations between the Council and the European Parliament set out in Articles 250 and 251 Treaty establishing the European Community (the "**TEC**").
7. The Treaty of Lisbon expanded the scope of codecision to reach 85 activity areas, from 44 activity areas under the Treaty of Nice. Source: European Parliament Guide to how the Parliament co-legislates under the Treaty of Lisbon, January 2012 www.europarl.europa.eu/code/information/guide_en.pdf
8. In specific cases laid down in the Treaty, legislative proposals can also be submitted on the initiative of Member States, on a recommendation by the European Central bank, or at the request of the Court of Justice. In these cases certain provisions concerning the role and prerogatives of the Commission do not apply (Article 294 (15) Treaty on the Functioning of the European Union (the "**TFEU**").
9. Also sometimes called the "regulatory committee"
10. Source: <http://www.euractiv.com/climate-environment/eu-carbon-market-hit-fresh-low-b-news-517347>
11. In the context of the "Backloading" proposal, this was the Environment, Public Health and Food Safety Committee (ENVI)
12. 48 votes in favour and 16 against.
13. The "Stop-the-clock" proposal is a proposal from the Commission to temporarily make available to airline operators derogation from its compliance with the EU ETS for those international flights that land or take off in the EU but originate or end outside the EU. This proposal was necessary due to the increasing opposition to the extra-territoriality of the EU ETS brought to bear by the governments of Russia, China and the United States because of the compliance obligations on its airlines.

14. This refers to the case where the report has been adopted in parliamentary committee with a 90% majority and the rapporteur requested that it report be voted in plenary without further amendment or debate.
15. In preparation for the next step a draft amendment had been placed before the Climate Change Committee on 23 January 2013 but became redundant given the result of the plenary vote.
16. A proposal to formally adopt the earlier legislative resolution rejecting the Commission's "Backloading" proposal did not pass as there was insufficient support. This has given rise to confusion as to whether there is a clear position among MEPs.
17. While this is not explicitly laid down in the Treaty, it is widely accepted that acting by a qualified majority the Council may reject the Commission proposal as a whole. On the other hand, the Commission may decide at any time during the first reading wither to withdraw or to alter its proposal (Article 293(2) TFEU).
18. The time limit starts to run form the official receipt of the amendments resulting from Parliament's second reading (with a possible one-month extension if agreed).
19. With a possible one-month extension if agreed.
20. Amendments must introduce a compromise between the positions of the co-legislators, must concern a part of the Common Position which did not appear in, or is substantially different from, the Commission's initial proposal and seek to take account of a new fact or legal situation which has arisen since the first reading. If new European elections have taken place, the rules for first reading will apply.
21. An absolute majority requires more than 50% of all members, irrespective of the number of those voting.
22. With the possibility of a further two-week extension if agreed.
23. Commission Regulation (EU) No 389/2013 of 2 May 2013
24. Regulation No. 182/2011
25. in accordance with Article 291(2) of that Treaty
26. Where a basic act is adopted under the ordinary legislative procedure, either the European Parliament or the Council may at any time indicate to the Commission that, in its view, a draft implementing act exceeds the implementing powers provided for in the basic act. In such a case, the Commission shall review the draft implementing act, taking account of the positions expressed, and shall inform the European Parliament and the Council whether it intends to maintain, amend or withdraw the draft implementing act (Article 11 Regulation (EU) No. 182/2011).