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Court ruling need not cause the carbon market to unravel

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There was some consternation among climate change campaigners last week when the European Court of First Instance ruled that the European Commission had exceeded its powers in 2007 by rejecting the national allocation plans (NAPs) of Poland and Estonia. The Commission had cut the NAPs back by around 27% and 48% respectively from what was originally proposed by the governments.

Carbon market participants were quick to deplore the "uncertainty" over the phase-2 (2007-12) allocation, fearing a "very bearish" effect on EU allowance prices, which duly dropped by 3.9%. The media decried a ruling that would threaten to "unravel Europe's carbon market". Oddly enough, the controversy is about whether the European Commission can impose a cap on member states' CO2 emissions covered by the Emissions Trading System, a question that, by adopting the energy and climate package in December 2008, EU member states answered with a unanimous 'yes'.

An impractical decision?

Among other things, the Court ruled that although the ETS Directive bestows upon the Commission the right and duty to object to NAPs that are not in line with the Directive and other EU law, it does not entrust it with the power to take the final decision on the total number of allowances. This right, according to the Court, rests with member states. At the time of the decisions on the NAPs, the Commission applied a standard formula, against which it judged all member states, thereby setting the level of allocation. While legally correct, the Court's decision is not very practical, and leaves certain matters unresolved. The NAP's total figure needs to be approved by the Commission to enter into force. Yet the Commission cannot impose a figure. It is difficult to see how a solution could be reached easily if the Commission and a member state disagree, except through further litigation.

Will Europe's carbon market unravel?

Much therefore depends on whether there is a rapid political settlement or a drawn-out legal battle. The latter would mean that the Commission keeps on rejecting the Polish and Estonian NAPs. A preferable and more likely alternative would be to find a political settlement with Poland, Estonia and other member states that have taken the matter to court. There are already signs of a move in this direction. Polish Environment Minister, Tomasz Chruszczow was quoted in Bloomberg as saying: "The Commission has an ally in us in its vows to protect the integrity of the European carbon market".

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In an attempt to calm troubled waters the Commission reiterated its commitment to ensure: “integrity, predictability and stability” in the market in its press release of 24 September.

Until new allocation plans are accepted by the Commission, the Polish and Estonian allocations will be the basis for companies in these countries to trade in the ETS, which they can comfortably do as there are no signs of a dramatic shortage. Actual 2008 emissions in Estonia and Polish NAPs correspond closely to those anticipated in the Commission 2007 Decision.

Most importantly for the carbon market, additional Polish and Estonian allowances will not come to the market, at least not for the time being. First, the Commission will need to approve the (new or old) NAPs. It is uncertain whether additional allowances will come to the market at all. Poland and Estonia might have a hard time arguing for additional allowances (beyond those approved by the Commission) in times of economic crisis and collapsing economic growth. In the medium term, an increase in the total number of allowances is still possible, not least to allow Poland and Estonia to claim victory. This is unfortunate and does not help to achieve long-term EU climate change objectives, but should not ring any alarm bells yet. If Poland, Estonia and the Commission really intend to maintain the integrity, predictability and stability of the carbon market, as they claim, the increase may be low – and less than fluctuations due to changes in weather, gas prices and economic growth. By now the ETS market should be robust enough to cope with this. Continued uncertainty about allocation would be a far greater inconvenience.