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The Fuel Emissions Trading Act – Introduction of a National Emissions Trading System in Germany

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On 1 January 2021, the national fuel emissions trading system (*nationaler Emissionshandel* – “nEHS”) started in Germany. The nEHS is designed as a supplement to the European emissions trading system (“EU-ETS”) and introduced a CO₂ price for emissions from the heating and transport sector. The legal basis for the nEHS the Fuel Emission Trading Act (*Brennstoffemissionshandelsgesetz* – “BEHG”) and various regulations for implementation, such as the Emission Reporting Regulation 2022 (*Emissionsberichterstattungsverordnung* – “EBeV 2022”) and the Fuel Emission Trading Regulation (*Brennstoffemissionshandlungsverordnung* – “BEHV”) which were both adopted in December 2020. Moreover, the Federal Ministry for the Environment has published a draft for a BEHG-Carbon-Leakage-Regulation (*BEHG-Carbon-Leakage-Verordnung* – “BECV”). In this paper, we describe the key points of the nEHS.

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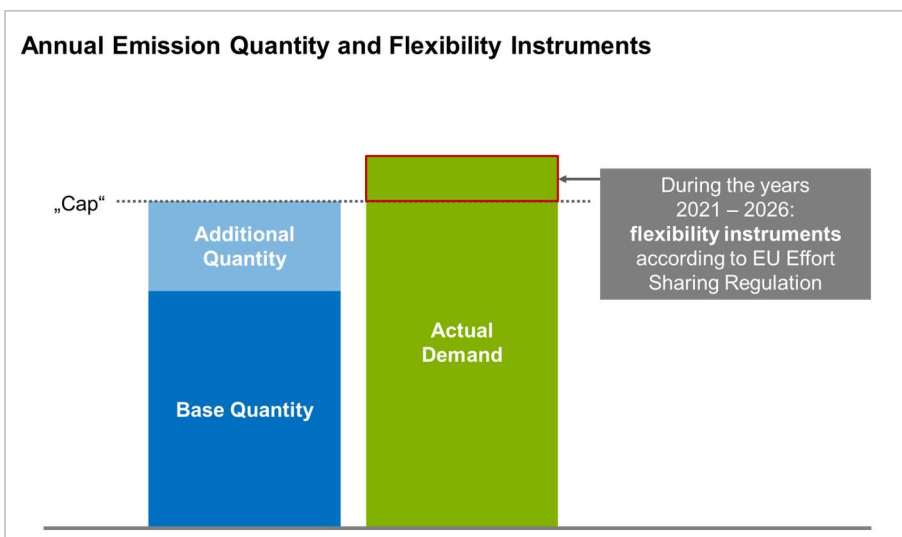
1. Background

The European Union and the Federal Republic of Germany have joined the Paris Agreement of 2015. By ratifying the Paris Agreement, the signatory states commit themselves to limit the global temperature increase to well below 2 °C in comparison to pre-industrial levels and to further efforts to restrict the rise to 1.5 °C. In order to be able to meet these commitments, the EU member states are also obliged to reduce national greenhouse gas emissions outside the sectors covered by the EU-ETS as set out in the EU Effort Sharing Regulation (EU) 2018/842. According to this regulation, Germany shall reduce its greenhouse gas emissions by 38 % compared to 2005 until 2030. On a national level, climate protection and sectoral targets as well as the goal of greenhouse gas neutrality by 2050 were legally established in Germany through the Federal Climate Protection Act dated 12 December 2019.

Against this background, the German legislator passed the BEHG at the end of 2019. The BEHG forms the legal framework for the nEHS. Numerous details have been or still need to be specified in implementing regulations. The BEHG contains 13 authorizations to issue implementing regulations. So far, only two have been issued: the Emission Reporting Regulation 2022 (EBeV 2022) and the Fuel Emission Trading Regulation (BEHV).

2. How does the nEHS work?

The nEHS works – similar to the EU-ETS – according to the principle of "cap and trade". The right to emit CO₂ (or to place fuels that cause CO₂ emissions on the market – *Inverkehrbringen*) is limited and thus becomes a scarce commodity. These emission allowances are then sold or auctioned off in the form of emission certificates and can be traded with other market participants.



In order to achieve a limitation of the emission certificates, a so-called annual emission quantity, which consists of a "base quantity" and an "additional quantity", is determined for each calendar year within a trading period. The base quantity corresponds to the maximum amount of fuel emissions that Germany is allowed to emit outside the EU-ETS in accordance with the reduction obligations of the EU Effort

Sharing Regulation. The additional quantity corresponds to the quantity of fuel emissions that are subject to both the nEHS and the EU-ETS (these emissions are not included in the base quantity). Annual reductions lead to a steady decrease of the emission quantity.

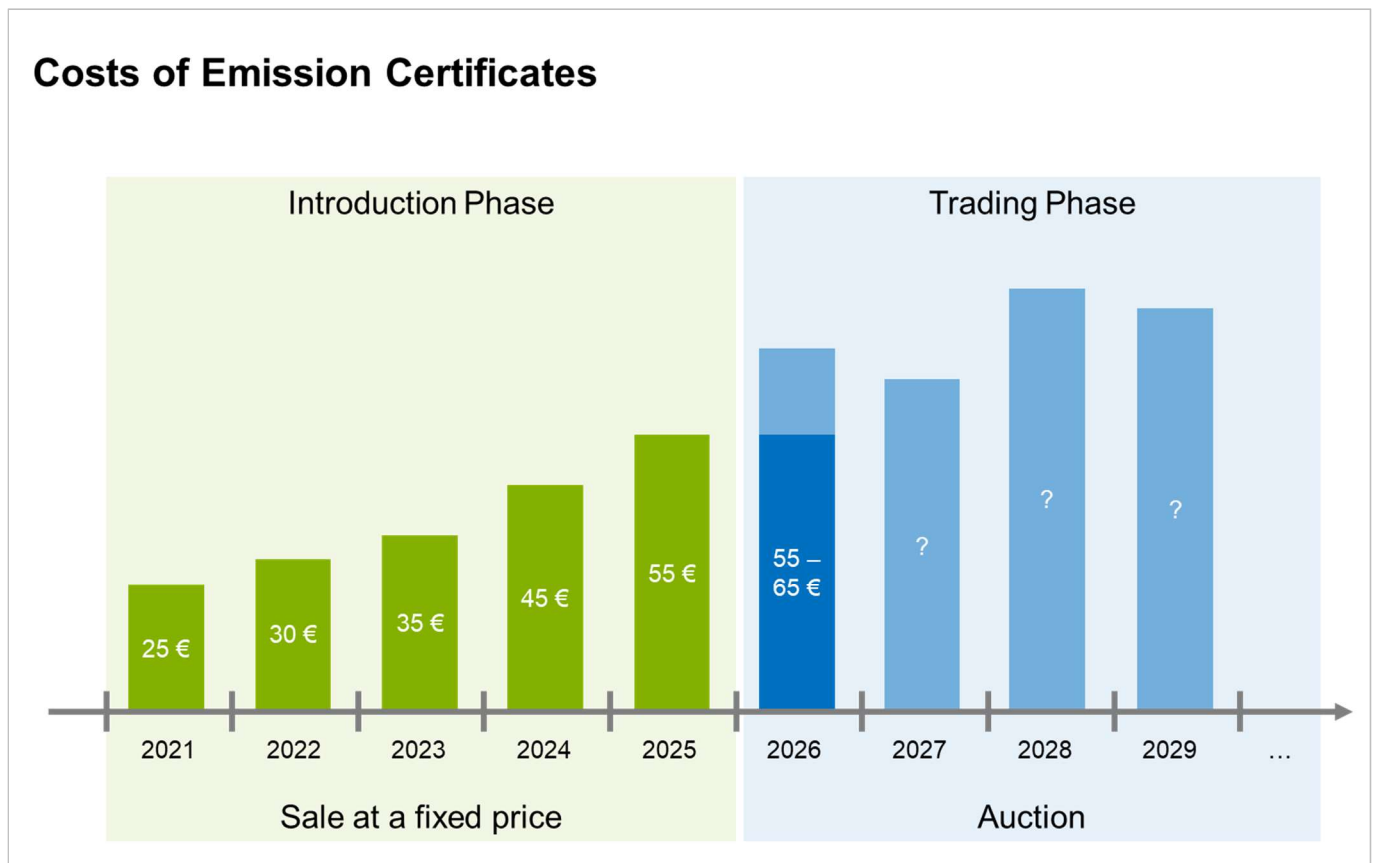
During the so-called introduction phase (2021 to 2025) and for the duration of the application of a price corridor (2026), it may happen that the annual emission quantity for a calendar year within the trading period is exceeded. As far as the annual quantities of the EU Effort Sharing Regulation cannot be met anymore, the additional demand for emission certificates will be covered by using flexibilities according to the EU Effort Sharing Regulation, e.g. by purchasing a corresponding quantity of emission allowances from other member states.

The increasing market prices provide a financial incentive to invest in climate protection measures or to avoid emissions. Market-based emissions trading reduces emissions where it is economically most cost-effective. Thus, individual reduction requirements are not necessary.

3. What are the costs of emission certificates?

During the introduction phase (2021 to 2025), the emission certificates are sold at a fixed price that increases annually. The expected costs per ton of CO₂ during this period are therefore predefined. In the subsequent so-called trading phase (starting in 2026), the certificates will be auctioned, whereby in 2026 a price corridor of 55 € to 65 € will still apply. After 2026, the price will be determined by the market.

The emission certificates issued during the introduction phase are valid for the year for which they are issued and the respective preceding year, while the certificates auctioned during the trading phase are valid for the entire trading period (until 2030).

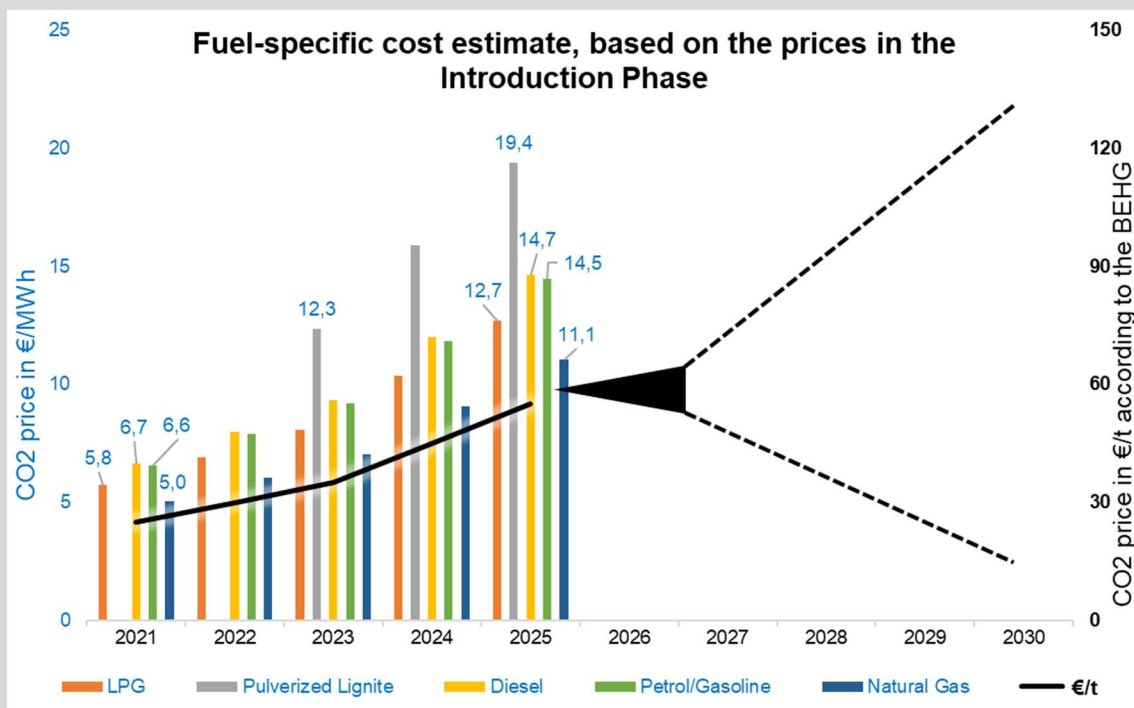


Economic dimension of the nEHS

By introducing the nEHS, the BEHG will in aggregate cause significantly higher costs and revenues than the EU-ETS:

- Price development: The Federal Republic of Germany raised 13.6 billion € in the eleven years from 2008 to 2019 through the sale of EU-ETS emission rights. According to the DEHSt, the majority of this amount accrued in the last three years. The reason for this is the strong increase of the market price for emission rights, which at the time of the first publication of this paper (November 2020) was about 25 €/t. This corresponds to the price for emission rights under the nEHS in the *first* year of the Introduction Phase (i.e. in 2021).
- Limited scope of the EU-ETS: The installations, which fall under the EU-ETS, have emitted less than half of the German CO₂ emissions, approx. 45% (2019).
- Allocation of free emission allowances: In 2019, German facilities under the EU-ETS emitted around 363 million tonnes CO₂ of which 141 million tonnes (38.8%) have been covered by free allocations.

After latest adjustment of the price path of the nEHS to initially 25 €/t in 2021, the Federal Ministry for the Environment (BMU) estimates the revenue and thus the costs incurred by the BEHG to be at 7.4 billion € in 2021. From 2023 onwards, the scope of the BEHG will be extended to other fuels, such as coal products, which are not covered by the EU-ETS. According to the currently established price path, the costs per ton of CO₂ will rise to 35 €/t in 2023, generating revenues of 10.5 billion € in 2023.



4. Which fuels does the nEHS cover?

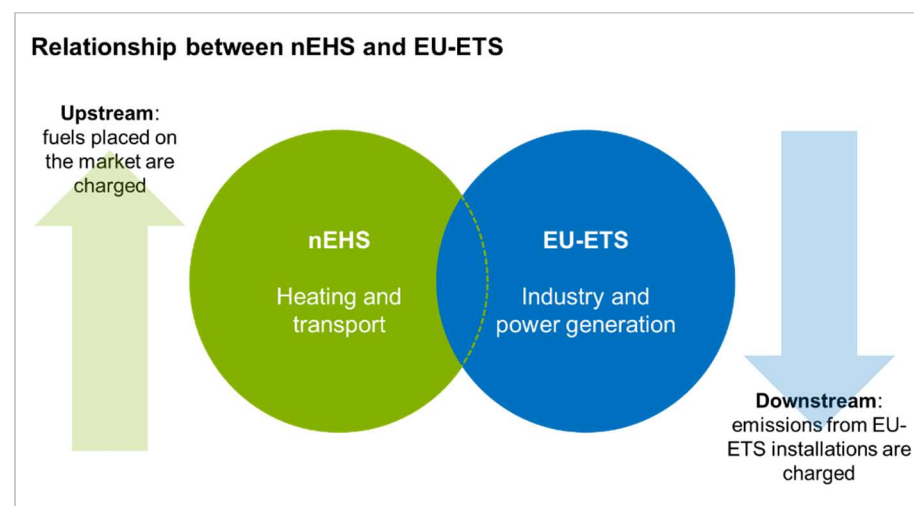
In the years 2021 and 2022, the nEHS will only cover the so-called main fuels, such as petrol, diesel, natural gas, liquid gas, heating oil etc. (cf. Annex 2 to the BEHG). From 2023, other fuels such as coal, vegetable oils etc., will be added to the scope of application (cf. Annex 1 to the BEHG). Biomass is generally included in the scope of the BEHG, but there is no obligation to surrender certificates for emissions from biogenic fuels as long as those fuels meet certain sustainability criteria.

With regard to certain fuels, it is currently still unclear or controversial whether they are or should actually be included in the scope of the nEHS. This applies, for example, to municipal waste as well as other fuels that are used in special processes (e.g. for the thermal treatment of hazardous waste and exhaust air treatment) or that are unavoidably produced in certain processes (e.g. residual gases in the production of hydrogen/synthesis gas). Sewage sludge, on the other hand, will be treated the same as biogenic fuel emissions according to the first amendment to the BEHG in November 2020.

The fuels are covered by the BEHG as soon as they are "placed on the market" (*in Verkehr gebracht*), and not at the time of actual emission. The point in time when the fuels are placed on the market corresponds to the moment at which the energy tax arises according to the Energy Tax Act (EnergieStG). This link to the Energy Tax Act is intended to limit the administrative burden for the affected companies.

5. What is the relationship between the EU-ETS and the nEHS?

The nEHS is intended to supplement the EU-ETS and, according to the intention of the legislator, should not lead to an additional burden for plant operators already covered by the EU-ETS. However, due to the



different approaches for charging the CO₂ costs, double charging may occur if the fuel is covered by the nEHS (so-called upstream approach of the nEHS, in which the placing of fuels on the market is charged) and used in a plant already covered by the EU-ETS (so-called downstream approach of the EU-ETS, in which emissions from a plant are charged). According to the BEHG, such a double burden resulting from the use of fuels in

a plant that is subject to the EU-ETS has to be "avoided in advance if possible". The details of this "ex ante exemption" are regulated by the EBeV 2022, which came into force in December 2020 (see also question 8).

6. Who is the addressee of the BEHG?

The obligations of the BEHG are essentially directed at the so-called “Responsible Party” (*Verantwortlicher*). Responsible Party is defined as “a natural or legal person or partnership that is considered to be a tax debtor according to § 2 para. 2, even if a tax exemption procedure will follow”. Therefore, the party that is obliged to pay taxes on the fuel in question under the Energy Tax Act is to be qualified as the Responsible Party.

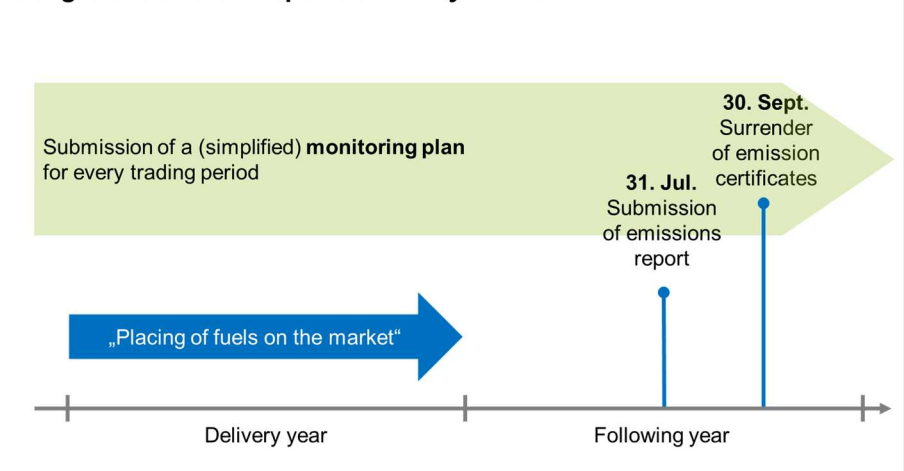
7. What are the obligations of the Responsible Party?

The BEHG contains three essential obligations of the Responsible Party:

- Submission of a **monitoring plan** (§ 6 BEHG): The Responsible Party shall submit a monitoring plan for each trading period. The monitoring plan sets out the method used to determine fuel emissions and for reporting purposes. If standard emission factors are applied, a simplified monitoring plan is sufficient. The monitoring plan has to be approved by the German Emissions Trading Authority (“DEHSt”). The details, such as minimum content and submission deadlines, will be outlined in an implementation regulation. For the years 2021 and 2022, the obligation to submit a monitoring plan (according to the EBeV 2022) is not applicable.

- Submission of an **emissions report** (§ 7 BEHG): The Responsible Party shall also determine the fuel emissions for the fuels placed on the market in a calendar year and submit a report to DEHSt by 30 July of the following year. The information provided in the report have to be verified by an inspection body (*Prüfstelle*).

Obligations of the Responsible Party – Timeline



However, this obligation does not apply to the years 2021 and 2022 according to the EBeV 2022. The details of the determination of fuel emissions are regulated in the EBeV 2022 (please see also question 8).

- **Surrender** of emission certificates (§ 8 BEHG): The Responsible Party is obliged to surrender emission certificates to DEHSt by 30 September of a year corresponding to the reported total amount of fuel emissions. The deadline for the additional purchase of emission certificates for the preceding year (max. 10% of the quantity already purchased), which applies during the introduction phase (2021 to 2025), has been extended from 28 February to 30 September of the respective following year as part of the first amendment to the BEHG.

8. How does the Responsible Party calculate the relevant fuel emissions?

The calculation of the relevant fuel emissions for the years 2021 and 2022 is regulated in the EBeV 2022 (and will also be regulated in a separate regulation for the period thereafter). Annex 1 to the EBeV 2022 contains a specific calculation formula consisting of three steps:

- First: the total amount of fuel emissions resulting from the fuels placed on the market in the respective calendar year is determined (§ 5 EBeV 2022). For this purpose, the fuel quantity, which has to be declared in the energy tax notification, is multiplied by the following calculation factors: conversion factor, calorific value and emission factor. For the deductible bioenergy share an emission factor of zero can be applied (§ 6 EBeV 2022).
- Second: in order to avoid double counting (*Vermeidung von Doppelerfassungen*), the emissions that were already subject of emissions reporting under the nEHS are deducted (§ 10 EBeV 2022). A deduction is also made for the material use (*stoffliche Nutzung*) of natural gas (§ 10 para. 4 EBeV 2022).
- Third: in order to avoid double charging from the EU-ETS and the nEHS (*Vermeidung von Doppelbelastungen*), the Responsible Party can also deduct an amount of fuel emissions corresponding to the fuel quantity delivered to a company in the respective calendar year for the use in an EU-ETS installation (§ 11 EBeV 2022).

There are still many open questions when it comes to the material use of natural gas and the avoidance of double charging in particular. For example, at the time of delivery or invoicing, the Responsible Party often does not know, or does not know with sufficient certainty, whether and to what extent the natural gas is actually used as a material or a fuel in an EU-ETS installation. It will therefore tend to first add the CO₂ costs to the fuel price. Even if a corresponding refund will be granted at a later stage, this practice would initially affect the liquidity of the consumer concerned.

The inadequate provisions on avoiding double charging (use of fuels in an EU ETS installation) of the draft version of the EBeV 2022 have been significantly revised in the version that has recently entered into force in order to provide more legal certainty in this respect. According to this, the responsible party and the supplied company must submit two identical declarations to the competent authority (i.e. the DEHSt) stating that the costs for emission certificates are not included in the contractually agreed fuel price. In addition, the Responsible Party has to provide the DEHSt with certain verifications, in particular regarding the quantity of fuel delivered and used in the EU ETS installation. However, risks remain for both sides. Therefore, it is advisable to stipulate the specific handling (e.g. wording of the declarations, obligations to cooperate, etc.) contractually between the Responsible Party and its customer.

9. What applies to the material use of fuels other than natural gas?

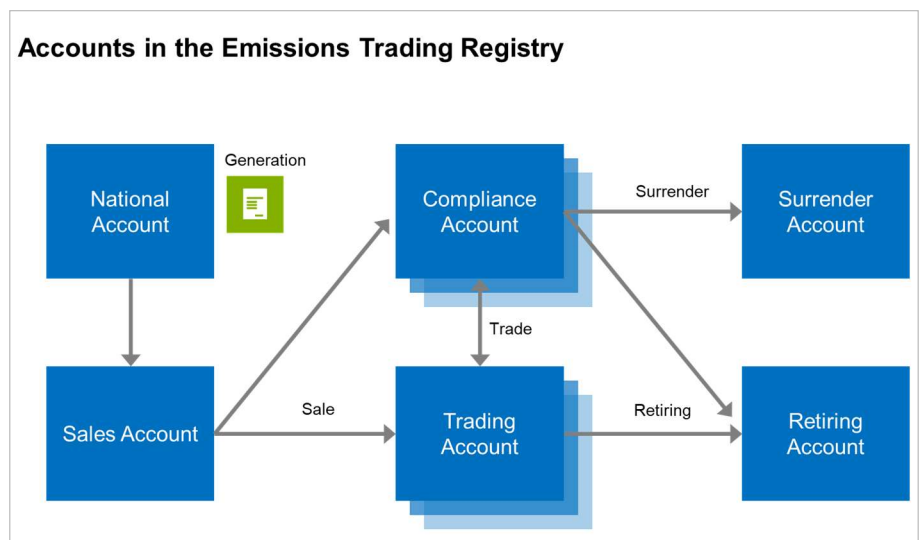
The material use of fuels other than natural gas (which may be deducted when determining the relevant fuel emissions, see question 8) does also not result in a CO₂ price. This is because the material use of such fuels is not subject to energy tax, thus they are not considered as being "placed on the market". However, the details about how the exemption of such fuels is handled in practice have so far been

inadequately regulated. At the time of delivery or invoicing, the Responsible Party does not yet know for sure whether and to what extent its customer uses the fuel materially, so that an "ex ante exemption" from the CO2 costs may be difficult in individual cases.

10. How does the trade with emission certificates in the Emissions Trading Registry work?

The BEHG regulates in detail how trading of certificates under the nEHS works. The so-called "Competent Authority", i.e. the DEHSt, which is affiliated to the Federal Environment Agency, manages and administers the emissions trading registry. In this registry there are different accounts with different functions:

- **National Account:** Account of the Competent Authority where the emission certificates are generated. The generated certificates are transferred to the sales account of the so-called "Commissioned Body" during the introduction phase.
- **Sales Account:** Account of the Commissioned Body which is responsible for the sale of emission certificates at a fixed price during the introduction phase. The delivery takes place when the Commissioned Body transfers the sold emission certificates from the sales account to the account of the buyer.
- **Compliance Account:** Account of the Responsible Party, which can be used for trading emission certificates, and in particular also for the surrender of emission certificates according to the obligation of the Responsible Party.



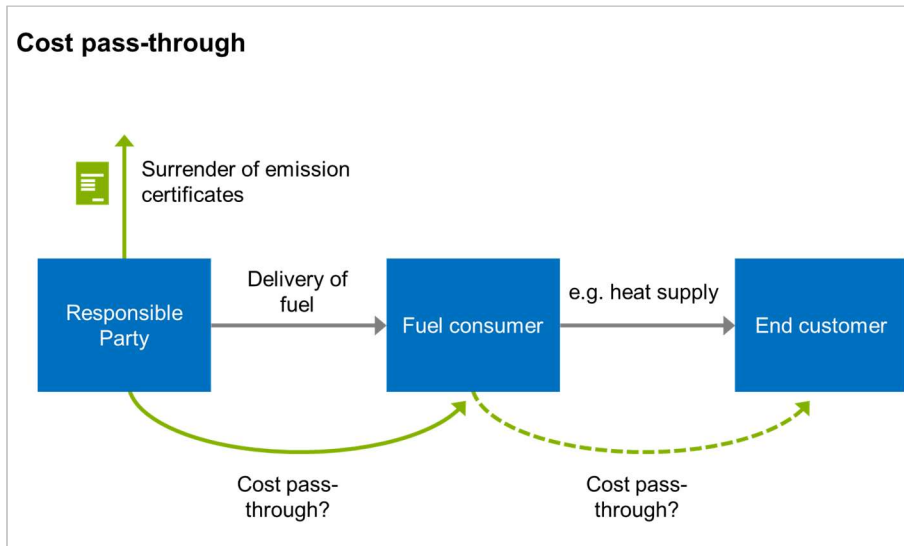
- **Trading Account:** Account of a natural or legal person which allows to participate in trading of emission certificates. It is not possible to surrender emission certificates from the trading account.
- **Surrender Account:** Account of the Competent Authority to which the Responsible Parties shall transfer the emission certificates to be surrendered.
- **Retiring Account:** Account of the Competent Authority to which certificates that are to be retired are transferred (e.g. emission certificates that have become invalid).

11. Can the Responsible Party pass on the costs from the nEHS to its customers?

A pass-through of CO₂ costs to consumers is in line with the intention of the legislator as well as the purpose of the BEHG. This is because only the consumer of the fuel or the party causing the emissions is able to reduce the emissions through its behaviour. However, the BEHG does not contain an explicit

provision, which sets out the pass-through of costs to customers.

Therefore, the question of the extent to which costs can be passed through depends largely on the individual contractual arrangements between the parties (fuel supplier and fuel consumer and, if applicable fuel consumer and end customer, e.g. in the heating sector). If there is no explicit provision in the contract, it might be possible,



for example, to apply the taxes and duties clause or a price adjustment provision with indexation, which includes the CO₂ costs, or other price adjustment rights. A distinction must be made between existing contracts where the additional costs arising from the BEHG were not yet foreseeable and new contracts where the contracting parties were able to foresee such costs at the time the contract was concluded.

When drafting price adjustment clauses for new contracts, the question arises how to deal with the additional costs in the period from 2026 onwards. This is because the additional costs for this period are not foreseeable (unlike in the introduction phase with fixed prices). Some market participants include a clause in their contracts obliging the parties to negotiate in good faith and agree on an appropriate price adjustment.

12. Measures for the compensation of indirect burdens, in particular for avoiding so-called carbon leakage

§ 11 BEHG provides various measures for the compensation of indirect burdens, which still have to be specified in implementing regulations:

- Companies which suffer from **unreasonable hardship** due to the fuel emissions trading should receive financial compensation *"in the amount necessary to avoid the unreasonable hardship"* (§ 11 para. 1 BEHG). This provision does not apply to Responsible Parties.
- Operators of **EU-ETS installations** using fuels for which emission certificates have been surrendered under the BEHG and EU-ETS allowances must also be surrendered due to their use in the EU-ETS installation should receive full financial compensation (§ 11 para. 2 BEHG). This

provision applies to EU-ETS installations where it is not possible to avoid double charging when calculating the relevant fuel emissions.

- Finally, the legislator is authorized to regulate the necessary measures to **avoid carbon leakage** and to maintain the EU-wide and international competitiveness of affected companies (§ 11 para. 3 BEHG). In December 2020, the Federal Ministry for the Environment (BMU) presented the draft for a BEHG Carbon Leakage Regulation (BECV). According to this, companies can apply for financial compensation if they suffer disadvantages due to the CO₂ pricing under the nEHS. However, it is a precondition that the applying company operates a (certified) energy management system and invests in climate protection measures to a certain extent in return. Applications for compensation must be submitted by 30 June of the calendar year following the settlement year. The BMU assumes that around 1,500 to 2,000 companies will be eligible for subsidies.

13. What are the sanctions for violations?

§ 22 BEHG contains various penalties for violations of the BEHG. Violations of the above-mentioned three essential obligations of the Responsible Party (see question 7) may be sanctioned as follows:

- A violation of the obligation to submit a monitoring plan (i.e. the plan is *"not submitted, not submitted correctly, not submitted completely or not submitted on time"*) can result in a fine of up to € 50,000.
- If the obligation to submit an emission report is violated, the DEHSt can block the account of the Responsible Party. Although this does not affect the possibility to surrender certificates, the Responsible Party can no longer trade the certificates. Furthermore, the DEHSt can estimate the fuel emissions attributable to the Responsible Party. In addition, a fine of up to € 500,000 may be imposed.
- The violation of the obligation to surrender emission certificates leads to a payment obligation of the Responsible Party for each ton of CO₂ for which a certificate was not surrendered. The payment amounts to twice the respective fixed price per ton of CO₂ during the introduction phase and thereafter € 100.- per ton of CO₂ (linked to the European Consumer Price Index). The original obligation to surrender the certificate remains in place and takes effect in the year after the violation.

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