A legal analysis of whether the EU can require the fuel providers to pay for part of the extended Emissions Trading System rather than passing it all to consumers

Requiring oil majors to pay

by Aoife O'Leary, *Founder and CEO, Opportunity Green*

The European Commission (COM) has proposed including the road transport and buildings sectors in the EU Emissions Trading System from 2026 (known as the ETS2). The regulated entities will be the upstream providers of fuel, i.e., the oil majors such as Total, Shell, BP, Eni and Repsol. This legal analysis, commissioned by Transport & Environment, considers whether the oil majors can be required to absorb part of the ETS2 cost and concludes that there are at least two options the EU could use to do so.

To that end, three suggested options have been provided as examples of how this could be done. First, inserting provisions into EU Member State corporate governance codes. Second, using a system similar to the requirement in Belgium that if medicine costs exceed a certain value, pharmaceutical companies must pay into a social security fund. Third, regulated tariffs for electricity as in France.

Each of these options will be assessed from a legal perspective, and then a recommendation will be provided. In addition, as the options are either pricing- or levy-based, they raise questions about the legal base to be used. Consequently, the legislative procedure for adopting any measure will also be analysed. ■

Pricing transparency

Before any regulation can require the oil majors to absorb part of the ETS2 cost, it will be essential to know how much of that cost is being passed on. While the market sets prices at the pump, national taxes and other regulations constitute that price. Therefore, the first requirement should be that any supplier of fuel for road transport or buildings must provide a breakdown of the costs going into the price at the pump to describe how much of the price is determined by oil exploration and extraction, how much is national taxation, how much is the ETS2 price, and importantly, how much is profit. Commercial operators have no inherent right to keep this information secret.

If the EU passes a law requiring them to share the information, they must do so. The EU already mandates this for agriculture products, where price information is collected at each stage of the supply chain. Regulation for transport fuels would have to consider that some oil companies are vertically integrated, but the principle is the same. For road transport, the information could be added to the EU oil monitor, which is published regularly.

In addition, it will be important for the EU to analyse fuel prices for road transport and buildings at a more macro level, i.e., following national and EU level prices as the sector enters the ETS2 to understand how much of the ETS2 price is being passed onto consumers. However, it would be difficult to tell, at any precise moment, how much was being passed onto consumers as both the ETS2 price and the price at the pump change frequently. Thus, the analysis would have to be carried out yearly (or perhaps more often, such as every quarter) to analyse the pass-through percentage.

Corporate governance codes

Many EU Member States have corporate governance codes which cover topics such as executive pay and shareholder protection. While, in theory, the EU could require the Member States to place requirements on oil majors into their governance codes, several considerations make this not the most favoured option.

The Belgian Code on Corporate Governance (previously known as the Code Lippens) applies to companies listed on the Belgian stock exchange. There is a separate code for non-listed companies in Belgium, the Code Buysse, which seems to be the pattern in several Member States. Meanwhile, other Member States only have corporate governance codes for listed companies. Thus, an issue arises if not all the providers of road transport and buildings fuel are listed on stock exchanges across the EU (complete analysis of whether these fuel providers are listed on stock exchanges is beyond the scope of this paper).

The EU has a choice of instruments when it acts but cannot require Member States to put EU legislation in a particular place in their legislative codes. Suppose the EU chooses to use a Regulation as its instrument. In that case, everything in the Regulation is directly effective in Member State legal systems without any transposition required, but this does not place the measures into any particular place in Member State legislative systems.

The EU could also put a requirement in a Directive, an instrument of harmonisation of law across the block. In this case, it will require transposition in the EU Member States, but as it is an instrument of harmonisation, how the provisions are transposed is left to the individual Member States. Another option is that the EU could issue a recommendation or opinion. Still, these are non-binding in nature – and this would not be a suitable legal instrument for a requirement involving payments.

However, the EU can require certain outcomes, regardless of the legal instrument chosen, and to the extent that a Member State not placing a requirement in the governance code meant that the outcome was not achieved, the EU could force compliance.

Finally, as fully discussed in the final section of this article, the most suitable legal base for the measure is environmental, which has little linkage to a corporate governance code and could therefore raise questions around the appropriate legal base.

Therefore, the most critical consideration for EU law is the content of the law rather than the placing within the Member State legal order. The rest of this analysis will consider the content of the law, which could simply be part of the future ETS2 legislation.

Regulated tariffs

The French energy system is based on regulated access to gas and electricity with a standard charge (determined by the Commission de régulation de l'énergie) for the use of the networks. This charge accounts for about 40% of the price paid by the final consumer. A similar arrangement for road transport could involve regulating the price at the pump or the wholesale price of transport fuel.

The EU regulation of mobile phone tariffs provides a useful precedent. The EU has placed several caps on wholesale and retail charges. This was adopted using the legal base of harmonising the regulation of the internal market (Article 114 of the Treaty on the Functioning of the European Union, TFEU). Still, several mobile phone operators challenged whether the EU had the authority to issue such price caps and whether, if the EU did, the measure was proportionate (Case C-58/08 – Vodafone and others). The challenge failed on both counts.

The challenge to the EU's authority to cap prices came about because under TFEU Article 114 there is a requirement for divergent laws to exist before the EU can step in and regulate. Mobile phone providers argued that there were no divergent laws, just divergent prices, but the Court of Justice of the European Union (CJEU) dismissed this as being manifestly false.

Secondly, and more interestingly for the purposes of considering a price cap for road transport, was the argument of whether the regulation from the EU was proportionate to the aim to be achieved. All EU legislation must comply with the principle of proportionality which is that the regulation must only go as far as is necessary to achieve the stated aim. The mobile phone operators claimed that regulating wholesale pricing would only have been a more proportionate measure, and regulating retail pricing was beyond the minimum required to meet the aims of the measure.

The CJEU dismissed the challenge to proportionality as the retail price cap "ought to ensure that retail charges for Community-wide roaming services provide a more reasonable reflection of the underlying costs involved in the provision of those services than has been the case." The CJEU stated further, "reductions in wholesale prices might not be reflected in lower retail prices for roaming owing to the absence of incentives for that to happen [...] there was no competitive pressure on operators to pass on that reduction." The CJEU was upholding the right of the EU to reflect reasonable costs and, in effect, not allowing mobile phone providers to receive excessive profits. Reliance was made on the recitals and impact assessment of the mobile phone pricing regulation, which clearly set out the objects of the regulation and the analysis showing that without regulating retail prices, the desired outcome might not be achieved.

This supplies a direct precedent for the EU to regulate excessive profits or a retail price cap on road transport fuels. It would be ideal if the objects of the regulation are set out clearly in the legislation's recitals, and there is a robust impact assessment for the CJEU to rely upon if the legislation is challenged.

However, the lack of an impact assessment that looks at the question of the oil majors absorbing some of the ETS2 cost or the impact of a retail price cap would not be fatal to any legislation surviving, especially if there are robust recitals explaining the reasoning for the measure and stating that the measure is proportionate to the aim and the minimum required for that aim to be achieved.

Levy on turnover

Belgium has a levy on the turnover of pharmaceutical companies if the state budget for medicines is exceeded. In Italy, there is a similar provision where pharmaceutical companies must cover 50% of the overrun if the "direct purchase budget" for medicines is exceeded. A similar provision could be introduced where a levy is placed on the turnover of entities that provide fuels for road transport.

Road transport fuel suppliers are highly concentrated, with six companies covering 75% of sales in Germany and 20 companies covering 99% in the UK. Therefore, there is a relatively modest number of entities to which any turnover regulation would apply in the road sector (though it seems that the buildings sector is less concentrated due to the broader use of multiple fuel types).

However, one of the issues that would be difficult to navigate would be ensuring that the correct entity's turnover was assessed. Each oil company will have several company registrations across different countries with different incomings and outgoings booked to varying entities for tax efficiency. It could immediately be foreseen that oil majors could set up new companies to limit the amount of turnover assessed for any levy. Thus, it could prove complicated to design legislation that takes into account multiple entities to ensure the appropriate turnover is considered.

Conclusion on potential design options

Based on this analysis, regulating prices at the pump or mandating that if more than a certain percentage of the ETS2 price (or absolute euro value) is passed onto consumers, the oil majors must contribute a certain percentage in addition to the ETS2 price to a fund are options to be preferred. These will be discussed further, but first, the legal base for any measure must be considered as the EU only has the powers given to it in the Treaties and cannot step outside those powers.

Legal base

Whatever measure is adopted, the legal base will be important for determining the legislative procedure to be used. The current ETS uses TFEU Article 192 on the protection of the environment as its legal base, and the COM has proposed that the ETS2 will also use TFEU Article 192 as a legal base.

The default legislative procedure for measures using Article 192 is the ordinary legislative procedure which uses qualified majority voting in the Council. But if measures are "primarily of a fiscal nature" or "significantly affecting a Member State's choice between different energy sources and the general structure of its energy supply," then the special legislative procedure requiring unanimity voting in Council is required.

In addition, there is the question of whether a levy should move away from Article 192 entirely and be based on Article 113 on the harmonisation of taxation. The following sections will analyse each of these options in turn.

Significantly affect energy choice

Poland challenged the ETS Market Stability Reserve (MSR) on the basis that the price of allowances would influence the choice of production technology for future investment and thus impact the country's electricity production structure which would have a significant impact on Poland's choice of energy source (C-5/16 Poland v Parliament and Council). Therefore, Poland claimed that the MSR should have been adopted using the special legislative procedure (in which Poland would have had a veto).

But the CJEU rejected this challenge on the basis that a broad interpretation of measures which significantly affect a Member State's energy choice "would risk having the effect of making recourse to the special legislative procedure, which the TFEU intended as an exception, into the general rule. That conclusion is irreconcilable with the Court's case law, according to which provisions that are exceptions to principles must be interpreted strictly."

As the CJEU dismissed the claim by Poland that the MSR significantly affected its choice of energy sources and importantly ruled that any exemption be interpreted strictly, it is extremely unlikely that a measure to ensure that oil majors absorb a portion of the ETS2 would be found to significantly affect a Member State's choice between different energy sources.

While putting a cap on road transport and, more importantly, on building emissions could be said to affect a Member State's choice between different energy sources, this is inherent to the ETS2 itself and not the addition of any provisions requiring oil companies to absorb some of the ETS2 costs.

Primarily of a fiscal nature

It is further unlikely that the addition of a measure requiring the absorption of ETS2 costs by the oil companies could be seen as being "primarily of a fiscal nature" if the explicit aim of the action is reducing climate impacts. The primary objective of the ETS2 is to reduce emissions, not to raise government revenue. Adding a measure ensuring oil companies absorb some of the ETS2 cost would not alter that primary aim but simply be an addition to assist in achieving that goal.

The ETS2 could directly affect consumers if the full allowance price were passed through. While this should aid with moving consumers towards lowering their use of fossil fuels for transport and building heating, vulnerable consumers do not have the available capital to buy an electric car or retrofit their homes (as examples).

The COM recognises this and states it will create the Social Climate Fund (SCF) alongside the ETS2 to tackle this issue. Ensuring the oil companies either absorb some of the cost and/or contribute to the SCF would aid poorer households in moving to options for transport and heating that have lower climate impacts as these would be financed by the SCF or if the oil companies absorbed some of the cost, this would leave poorer households with more capital they could invest in measures to reduce emissions. In other words, ensuring that the aims of the ETS2 are more likely to be achieved.

Harmonisation of taxation

A provision to ensure oil majors absorb most of the ETS2 price would be a fully integrated part of the ETS2; there is no reason to believe such a provision should be based on a separate TFEU Article. However, it is possible that the claim could be made that any requirement for the oil companies to pay additional amounts is akin to a tax. Thus, its legal base should be that of Article 113 TFEU on the harmonisation of taxes (note the mobile phone tariff case discussed above related to Article 114 on internal market harmonisation, not 113). Using Article 113 as the legal base would mean any resulting measure must be enacted via unanimity in the Council. However, it is unlikely any such claim could succeed.

As long as the levy on the oil majors is primarily aimed at protecting the environment, rather than harmonising taxation across the EU, the use of Article 192 is more appropriate. The Court has held in C-45/86 Commission v Council that a specific legal base precludes the possibility of using a more general legal base. The environmental base is to be preferred between a legal base of primarily environmental action or taxation harmonisation for a levy on oil majors. Though such a measure would in a limited way harmonise taxation across the EU, it would be regulating the price due to a sought-after environmental impact rather than as a taxation matter per se.

This is important as the CJEU has held in the past that the legal basis for a legislative act "must rest on objective factors amenable to judicial review, which include in particular the aim and the content of the measure" (Case C-211/01 Commission v Council). In addition, the CJEU has stated that "if the examination of a Community measure reveals that it pursues a twofold purpose or that it has a twofold component and if one of these is identifiable as the main or predominant purpose or component whereas the other is merely incidental, the act must be based on a single legal basis, namely that required by the main or predominant purpose or component" (Case C-155/91 Commission v Council; Case C-36/98 Spain v Council). As the EU would be regulating based on environmental concerns, Article 192 TFEU should be the legal base.

Tackling social exclusion

Part of the aim of the SCF and any measure to have the oil majors absorb some of the ETS2 cost is to protect vulnerable consumers. However, this in and of itself cannot be the basis for any EU legislation as there is no legal base in the TFEU which could be relied on. Tackling poverty and social exclusion is one of the specific policy goals of the EU, but TFEU Article 153 calls for it to be achieved solely by non-legislative cooperation. Therefore, any aim of relieving poverty or protecting vulnerable consumers must always be secondary to achieving the climate goals of the legislation if it is to have the best possible chance of being adopted and surviving any potential legal challenge.

An alternative legal base would be the protection of consumers in Article 169. It aims to promote "the interests of consumers and to ensure a high level of consumer protection, the Union shall contribute to protecting the health, safety and economic interests of consumers, as well as to promoting their right to information."

There are two options for enacting legislation under this article – one is for "measures which support, supplement and monitor the policy pursued by the Member States." Requiring the oil majors to absorb some of the ETS2 cost would not be supporting policy pursued by Member States, so this option could not be used.

The other option uses Article 114 on the harmonisation of the internal market, which allows for measures to be adopted using the ordinary legislative procedure. However, there is no additional benefit to using this Article compared to using Article 192 on the environment. Indeed, separating the legal base for oil majors to absorb some of the ETS2 cost from the legal base for the rest of the ETS2 would make the measures more akin to a separate tax or levy.

Thus, the recommendation is to leave Article 192 as the legal base and ensure that environmental protection is the final measure's main aim.

Proposed regulation

Two options stand out as having the best potential: regulating prices at the pump or placing a requirement that if more than a certain percentage of the ETS2 price (or absolute euro value) is passed on to consumers, the oil majors must contribute a certain percentage in addition to the ETS2 price to the proposed SCF.

Option A: contribution to Social Climate Fund

The SCF has two aims. First: to finance direct income support for vulnerable households, such as by reducing electricity taxes and levies. Second: to support measures and investments that reduce emissions in the road transport and buildings sectors and, as a result, reduce fossil fuel costs for vulnerable households, micro-enterprises and transport users. These aims are essential in ensuring any regulation is not primarily of a fiscal nature as they are clearly stated to be environmental.

As an example of how this regulation could work, if the EU determines that more than 50% of the ETS cost is being passed onto consumers (via the price transparency information they have collected), then the entities in the road transport sector of the ETS2 must pay the average allowance cost for the ETS2 from the previous year for 20% the entities' emissions responsibility. The following example uses very simplified numbers for illustration purposes; an economic analysis should be carried out to decide the appropriate metrics.

The fictional oil company Totell surrenders 1,000 European Union Allowances (EUAs) in 2027 for its 2026 road transport emissions. Based on the information provided by Totell and its own analysis, the COM considers that Totell passed on 65% of the cost of the EUAs to the consumer. The average cost of a EUA during 2026 was €100. As the 65% pass-through is larger than the 50% cap, Totell must pay, in addition to the EUAs already purchased, 20% of 1,000 = 200, multiplied by the average EUA price of €100 = €20,000 into the SCF. A sliding scale could be set with larger penalties as greater proportions are passed on to the consumer.

This could even be simplified by requiring Totell to pay the same amount the company passed on in excess of the pass-through cap into the SCF. This would work the same as in the above example, but as Totell passed 65% through to consumers, which is larger than the 50% cap, Totell would be required to pay an amount equivalent to the 15% excess pass-through into the SCF.

Option B: a cap on retail prices

Another option would be for the EU to directly regulate road transport fuel retail prices. By doing so, the EU would essentially require the oil majors to absorb a certain amount of the ETS2 price as they would not necessarily (depending on prices) be able to pass it on.

The COM could set the cap by considering the information provided by the pricing transparency requirements discussed at the start of this analysis on a quarterly (or more frequent) basis. This would further the environmental aim of the ETS2 because it would reduce the amount that more vulnerable customers (and everyone else) pay so that they could more easily save up the capital required to install a heat pump or buy an electric vehicle (as examples).

However, the environmental purpose (important to ensure the legal base is not seen as "primarily of a fiscal nature") is less clear-cut as the consumers who save money due to the retail price cap would not necessarily invest these savings in measures that reduce climate change. Further, it does reduce the climate signal sent to all other consumers.

The recitals to the legislation would be key to ensuring a clear environmental benefit to this measure is articulated, which could be relied upon later in the case of any challenge to the regulation.

Conclusion

Multiple legal options are available to the EU to ensure that the fuel providers absorb the ETS2 cost. This piece considered using corporate governance codes, regulated pricing, and a levy on turnover.

The final conclusion presents two options. Option A is a hybrid that is mainly modelled on the turnover levy but considers the pass-through from the oil companies to the consumers and the ETS2 price for the penalty. Notably, the penalty should go to the SCF because it is designed to reinforce the aims of the ETS2 by supporting vulnerable households who might not otherwise be able to move their transport and heating consumption away from fossil fuels.

Option B would be for the EU to directly regulate the retail price of road fuel. Both of these options primarily aim to protect the environment, rather than having a financial aim, avoiding a requirement to use the special legislative procedure. However, Option A provides a clearer environmental benefit. Thus, it will be extra important if Option B is adopted to ensure that there is clear reasoning set out in the recitals to the legislation that could be relied upon in any subsequent challenge to the law.

Opportunity Green

Climate change is terrifying. But if the global community acts now, the solutions that reduce emissions also bring enormous opportunities for economic development, improved health and increased democracy. At Opportunity Green we help countries, civil society and business access those opportunities. Visit **www.opportunitygreen.org** to learn more.