



**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

Cancels & replaces the same document of 18 October 2010

Working Party No. 2 on Competition and Regulation

EMISSION PERMITS AND COMPETITION

-- Japan --

25 October 2010

The attached document is submitted to Working Party No. 2 of the Competition Committee FOR DISCUSSION under item VII of the agenda at its forthcoming meeting on 25 October 2010.

Please contact Mr. Sean Ennis if you have any questions regarding this document [phone number: +33 1 45 24 96 55 -- E-mail address: sean.ennis@oecd.org].

JT03292522

1. Introduction

1. With the enactment of the Kyoto Protocol in February 2005, Japan is obliged to reduce greenhouse gases (GHGs) by 6% from the base year 1990 during the period from 2008 to 2012. For this end, the government has been taking initiatives to implement various measures against the emission of greenhouse gases.

2. At present, a domestic emission trading scheme, which is equivalent to the nationwide-level, has not yet been introduced. However, in March 2010, the government submitted to the Diet the bill for the Basic Act on Global Warming countermeasures,¹ which introduces a domestic emission trading scheme by the cap and trade method.

3. Against the backdrop of this situation, in March 2010, the Japan Fair Trade Commission (JFTC) examined the issues from the viewpoint of competition policy with regard to a scheme that is expected to be implemented at the time domestic emission trading is introduced, as well as its ancillary private commercial transactions. In its interim report, the JFTC identified the potential impact on competition among enterprises by the expected introduction of emissions control and conducts by enterprises concerning emission regulations that would possibly pose a problem under the Antimonopoly Act. By analyzing the issues from the viewpoint of competition policy with a focus on basic issues concerning the design of the emission trading scheme, the impacts on competition and points to be acknowledged are summarized as follows.

2. Discussion points on competition policies regarding emission control

2.1 *The impacts of emission allowance allocation methods on competition*

4. The methods of emission allowance allocation, which serve as the premise of the emission trading scheme, are divided into two types: free allocation and auction. Each allocation method is outlined in the chart below.

Free Allocation	Grandfathering	Emission allowances are determined for business entities, etc., based on past emission results.
	Benchmarking	Emission allowances are determined for businesses (usually firms), etc., based on benchmarks, such as standard “GHG emission volumes per unit of production,” which are set for each industry sector.
Auction		Each business entity purchases necessary emission allowances by auction from the government.

¹ This draft law was submitted to the House of Councilors in June 2010 and its deliberation was started, but discarded with its deliberation suspended.

At the Ministry of Environment, how the emission trading system should operate, etc., has been discussed since April 2010 by the Domestic Emission Trading Subcommittee, Central Environment Council. Also, at the Ministry of Economy, Trade and Industry, the Working Group for the Policy Method was established under the Industrial Structure Council in June 2010. The Working Group reviews how measures should be taken against global warming issues, including a domestic emission trading system.

2.1.1 *Free allocation*

5. Free allocation methods of emission allowance include grandfathering and benchmarking. The following is the summary of impacts on competition that are common to these methods and the impact on competition brought by each method.

Impacts on competition common to both methods

- New entrants

In free allocation through grandfathering or benchmarking, how to treat new entrants is an issue as they do not have past emission data, which would be required in order to decide the allocation of allowances to enterprises in the scheme.

If new entrants without such data were required to purchase emission allowances whereas existing entities (incumbents) were allocated allowances, new entry into the business might be deterred because new entrants would have disadvantages in competing with incumbents. In the case of introducing free allocation, therefore, a certain consideration will be necessary from the viewpoint of equalizing competitive conditions between new entrants and incumbents. For example, a mechanism that allocates a certain volume of emission allowances to new entrants can be set in the scheme.

On the other hand, in the case of establishing a system in which new entrants are given a certain level of free allocation, an appropriate system should be put in place to secure fair competitive environments so that business activities against the aim of the scheme cannot be carried out. For example, enterprises without actual results should not receive excessive allocations by applying to the scheme, or enterprises should not profit on the sale of emission allowances if they do not actually operate despite being given free allocations.

- Emission allowance allocation to trade associations by the government

One of the possible emission allowance allocation methods would be for the government to allocate emission allowances to specific trade associations and then for those organizations to allocate a certain volume of emission allowances to each member enterprise. Such an allocation scheme to trade associations, however, could incur a few concerns, namely, (1) trade associations would determine the emission volumes and consequently production volumes of individual members, (2) the business activities of certain members could be restricted by an unfair allocation of the emission allowances by the trade associations, and (3) the business activities of members could be restricted by possible restriction on how to achieve members' emission obligations. Therefore, it is considered that emission allowance allocation through trade associations could be likely to distort competition among member enterprises.

- Closure of a place of business

In the case of closure of a place of business that has been allocated emission allowances, two options are possible, namely, (1) the emission allowances once allocated can be kept by the enterprise and transferred to another place of business in its possession and (2) excess emission allowances that have been created due to the closure of an existing place of business must be returned to the government. In the case of enterprises closing places of business with lower production efficiency and shifting their production to places of business with higher efficiency, option (1) gives incentives to enterprises to proactively close and consolidate the places of

business, whereas option (2) could give adverse incentives to enterprises to continue operation at places of business with lower efficiency in order to avoid handing over the emission allowances given.

Influence of each allocation method on the competition

- Grandfathering

There is a concern that grandfathering may distort competition when allocation is more favorable to businesses with lower energy efficiency (i.e. lower productive efficiency) rather than those with higher efficiency if the differences in energy efficiencies caused by past energy saving efforts, etc., are not reflected in the allocation.

In response to this issue, a special arrangement called “early action” could be set in order to allocate a certain volume of additional allowances with no charge to businesses that have made energy saving efforts, etc. In actually implementing such a special arrangement, however, decision making regarding which time period of the energy saving efforts can be covered and how these efforts can be examined, etc., could be a matter of arbitrariness and unfairness. Therefore, careful consideration to avoid such arbitrariness and unfairness is needed when such special arrangements are introduced. In designing how to determine the baseline year (baseline period) to calculate actual emissions, it is important to carefully consider not giving incentives to enterprises to continue inefficient production in order to secure their emission allowances.

In the industry sectors where technology for emission reduction has almost reached its limits and additional emission reduction costs are relatively high, enterprises would need to purchase emission allowances in order to increase their production, and competition would be based on the assumption that there are some constraints in production quantity in cases where enterprises would not earn profits due to the financial burden of purchasing emission allowances to increase production. In such cases, the production plan of each enterprise can easily be estimated if the allocated emission volumes, etc., are made public for the purpose of transparency in the allocation process under the circumstance of inactive trading of emission allowances, and this could consequently induce anticompetitive conducts that could be problems under the Antimonopoly Act, such as the allocation of quantity or production volume, etc., among enterprises.

- Benchmarking

As the mechanism of this method grants rewards to enterprises that retain emission efficiencies higher than the average, there is an incentive for enterprises to promote further emission reduction above the average level. Therefore, this method is expected to create competition promoting effects regarding production efficiency in cases where higher emission efficiency would lead to increasing production efficiency.

However, an issue arises when allocating emission allowances in the benchmarking method, that is, whether a uniform benchmark should be set for each industry sector or different benchmarks should be set to reflect the actual conditions of each enterprise if production technology, etc., are different in the same industry sector. It is considered that setting a benchmark for each production technology would result in giving less incentive to shifting to a production technology with higher production efficiency². Moreover, in general, emission allowances by benchmarking are

² For example, if different benchmarks are set for individual technologies with different emission efficiency in the power generation sector, such as coal power generation, natural gas power generation, etc., coal

calculated by multiplying activity volume by the benchmark. In the case of using production volume as the activity volume here, the same concern arises as in grandfathering, i.e., it could induce negative reactions in that enterprises would intentionally keep inefficient production.³

Benchmarks are usually set based on the average emission intensity for an industry sector, etc. If enterprises in different industry sectors are competing, however, there might occur an issue of securing equal footing among these enterprises since room for reducing emissions is different in each sector⁴.

Furthermore, past activity volume for a certain period is generally used as the activity volume of a business when determining emission allowances by benchmarking. In the case that expected production volume is used instead of the past activity and the allocated emission volumes, etc., are made public for the purpose of transparency in the allocation process, the production plans of each business are expected to be easily estimated and this could consequently induce anticompetitive conducts that could be problematic under the Antimonopoly Act, such as the allocation of quantity or production, etc., between enterprises.

2.1.2 Auction

6. Efficient allocation is expected in auction since the scheme allocates emission allowances using market mechanisms, which can secure transparency in the process of obtaining emission allowances as well as fairness of opportunities between new entrants and incumbents to obtain emission allowances.

7. However, because enterprises will have to bear the costs to purchase emission allowances, this scheme could induce a chilling effect on business activities of enterprises that cannot earn profits due to the additional burden of purchasing emission allowances.

8. In terms of the scale of auction, if the scheme is designed to restrict participants by such aspects as segmenting the market by industry sector, negative impacts on competition could emerge, namely, buyout of emission allowances and manipulation of transaction prices of emission allowances in order to eliminate specific enterprises such as new entrants, etc.

9. In addition, if information important for competition, such as the volume and the price of emission allowances that participating enterprises want to purchase, is disclosed as a result of an auction, such information will be an important sign that could reveal business plans, etc., to competing enterprises, and thus it could induce negative impacts on competition.

power generation which performs less efficiently will be allocated more allowances. Here, incentive to shift from a low efficient technology to a high efficient one would not work.

³ The same concern arises also in the case of calculating the activity volume by multiplying facility capacity by an operation rate. In this calculation method, however, it is still expected to give incentive to improving the facility capacity because such a negative factor can be eliminated by applying a standardized operation rate.

⁴ In such a case, equal footing is considered to be taken into account in the process of reviewing the BAT (Best Available Technology) in each sector by applying the method of utilizing BAT as a benchmark (to be calculated by accumulating emissions in the case of introducing BAT).

10. Based on the above issues, the Study Group on Government Regulations and Competition Policy⁵ evaluated methods of emission allowance allocation from the standpoint of competition policy and determined that allocation by auction is desirable from the viewpoint of minimally impacting competition among enterprises.

2.2 Cost containment measures

2.2.1 Use and restriction of external credits⁶

11. The use of external credits is generally considered desirable as enterprises will be able to have diverse options to fulfill emission reduction obligations and their use will make the impact of the obligations on the business activities of participating entities and consequently on competition relatively small.

12. On the other hand, use of external credits diminishes incentives to make self efforts to reduce emissions by enterprises, and thus restrictions for their use are set in some cases. However, if the use of external credits is excessively restricted under a circumstance in which emission allowance trading is not yet sufficiently activated, it might induce negative impacts on competition because enterprises might have no other choice but to restrict production due to a shortage of emission allowances or external benefits, for example.

13. Moreover, external credits are established without strict monitoring and verification in many cases. Therefore, it is appropriate to permit only the use of external credits that have been established through a certain level of strict monitoring and verification from the viewpoint of securing fair competition conditions.

2.2.2 Banking⁷ and borrowing⁸

14. As banking and borrowing provide enterprises with more options for fulfilling obligations other than through the sale and purchase of emission allowances or external credits, they can reduce the impacts of imposing emission reduction obligations on the business activities of participating entities and consequently on competition. Furthermore, they are expected to enable enterprises to flexibly make efforts to invest in emission reduction facilities for future emission reduction. With regard to banking and borrowing measures, moreover, there would be less concern that coordinated acts regarding prices and production volume are induced as it is difficult to speculate about the production plans of competing enterprises based on the relationship between emission volume and production volume in a certain period.

⁵ As of March 2009, this study group consists of 10 members comprising academics and experts that meet with the purpose of reviewing public regulations as well as policies for securing and promoting competition in related fields, considering the changing social and economic environment in Japan.

⁶ Apart from trading of emission allowances with other entities, this credit is recognized as a flexible measure for observance in the emission trading scheme.

⁷ Banking is a mechanism that allows participants to use the surplus of the emission reductions they achieved compared with the emission allowance given in one operational period to achieve the emission reduction obligation in the following period.

⁸ Borrowing is a mechanism that allows participants to achieve the emission reduction obligation in one period by using a part of the emission allowances in the following period even if actual achievement is not possible.

15. However, permitting banking and borrowing with no restriction would diminish incentives to trade emission allowances and external credits with other business entities in the market, and these kinds of trading might not be activated.

2.3 *Trading of emission allowances and external credits*

2.3.1 *Price restriction of emission allowances and external credits*

16. There will be a concern that the market mechanism itself might not function well for the trading of emission allowances in the case that maximum price restriction, etc., is set for emission allowances and external credits.

17. In the case that the maximum price of emission allowances and external credits is set lower than the emission reduction costs of enterprises, such a price restriction will diminish incentives to reduce emissions and develop technology because enterprises can achieve the emission reduction obligation by purchasing emission allowances and external credits. This will have negative impacts on competition in the technology market or R&D market related to emission reduction.

2.3.2 *Trading through an exchange*

18. Trading allowances and credits through an exchange contributes to securing businesses with diverse trading options and is also expected to produce an outcome to provide smoother trading opportunities through lowered transaction costs and price detection function.

19. On the other hand, in order for trading through an exchange to function effectively, it is necessary to ensure such conditions as free participation in trading, low participation cost, fair and timely disclosure of information about market trading price, and no manipulation of the market price.

20. However, information disclosure in trading emission allowances and external credits could induce anticompetitive conducts among enterprises, for example, in the case where a fact that a specific enterprise has offered to sell or purchase emission allowances and the information such as price and trading volume offered at that time are disclosed to the competitors which belong to the same market. Therefore, data disclosed by the exchange should be selected and treated with careful consideration.

2.4 *Other concerns*

2.4.1 *Regulations on small and medium-sized enterprises*

21. In relation to emission reduction costs to comply with the emission regulation and administration costs to verify emission volume, when there are fixed costs which participating business enterprises are required to bear regardless of their emission volume, the cost to comply with the regulation would be excessive for small and medium-sized enterprises if they are subject to the regulation even if their emission volume is small. In the case that these entities face financial difficulties in continuing their business due to such cost burdens, it might induce a decrease in the number of competitors in the market and consequently a negative impact on the competition.

3. Conducts of enterprises adhering to emission regulations which possibly become concerns under the Antimonopoly Act

3.1 *Joint conduct by enterprises, etc.*

3.1.1 *Joint conduct in the implementation of emission reduction*

22. Currently, in quite a few cases, trade associations develop a voluntary action plan to commit to emission reduction, and there are some cases of trade associations participating in the experimental introduction of an integrated domestic market for emissions trading⁹.

23. In the case that the government allocates a certain volume of emission allowances to individual businesses or establishments or assigns them a certain volume of emission reductions, a problem of a cartel on supply volume under the Antimonopoly Act could arise if enterprises in concert with others or trade associations determine the supply volume of products or services of each business based on these obligations. Furthermore, restriction¹⁰ by business enterprises in concert with others or by trade associations on methods to achieve obligations of emission allowances, despite no such regulation by the government, would pose a problem under the Antimonopoly Act.

3.1.2 *Joint conduct to respond to increase in cost burdens associated with emission reduction*

24. When enterprises are required to incur an obligation regarding emissions, these enterprises need to constantly bear additional costs in order to purchase emission allowances or external credits from other enterprises if necessary, as well as to reduce emissions by their own efforts. Furthermore, it is possible each enterprise needs to cover these burdens at the same time.

25. Enterprises could respond to such cost burdens by directly raising the prices of their products and services, but if only one enterprise does so, this may decrease its sales. Therefore, enterprises might have incentives to jointly raise the prices of products and services by a certain amount. Such conduct, however, will be a problem under the Antimonopoly Act.

3.1.3 *Joint research and development regarding emission reduction*

26. As a commitment to emission reduction, enterprises may jointly perform research and development (R&D) for innovative production technologies, etc., which lead to emission reduction. Joint R&D is considered to have a pro-competitive impact in many cases as it promotes innovation by making R&D activities more active and efficient through cost reduction, risk diversification, shorter development period, etc.

27. On the other hand, as joint R&D is an activity pursued by multiple enterprises, depending on the agreement on the joint research and development, the business activities of the participants could be unreasonably restricted and thus fair competition in the technology market and product market could be disturbed.

28. In principle, restriction of the licensing of technology as an output of the joint R&D to the third party per se would not be a problem. However, in the case that in an industry sector, for example, joint

⁹ Although in principle participation as an organization is not acceptable, the government allows it as a special case.

¹⁰ Examples are restrictions on credit volume and type that can be used for achieving the obligation, or restrictions on arrangement, facilities, etc., for achieving emission reduction.

R&D has developed an innovative technology that can achieve a substantial amount of emission reduction and other enterprises would not be able to continue their business activities without using this technology to reduce emissions, rejection of licensing the technology could be a problem of unfair trade practices (concerted refusal to trade, etc.), private monopolization, etc., under the Antimonopoly Act if offers are made with reasonable conditions regarding costs, etc.

3.2 *Unilateral conducts by enterprises*

3.2.1 *Conduct pertaining to the benchmark setting for the benchmarking method*

29. A benchmark needs to be set, when the benchmarking method is adopted as the means of emission allowance allocation. This benchmark is supposed to be established based on the most efficient technology in the process of manufacturing a specific product. In setting a benchmark jointly, if one of the enterprises was successful to persuade other enterprises to calculate the benchmark based on the most efficient technology it owns by offering its license at an extremely advantageous condition and then refuses to license it to other enterprises at a time when others become unable to replace it by different technologies, others may not be able to decrease the emission volume within their allotted emissions allowance. Such conduct that makes it difficult for others to use the technology and thus to continue their business activities might fall upon private monopolization or unfair trade practices (refusal to trade) and constitute a problem under the Antimonopoly Act.

3.2.2 *Conduct regarding implementation of the external credit scheme*

30. Large scale enterprises, etc., which desire to use the external credit scheme, possibly implement an external credit project by gathering group affiliated partners, suppliers, and enterprises which desire to have contracts with them in order to efficiently secure a certain volume of credits. In this case, there could be an issue of unfair trade practices (trading on restrictive terms) in relation to the Antimonopoly Act if a large scale enterprise has a business with its existing partners on condition that the external credit project is to be implemented only between them, which results in a reduction in business opportunities for its competitors which could not easily find alternative partners as a consequence.

31. Furthermore, in the implementation of the external credit project, there are cases in which additional cost burdens or decreases in profits could result because a smaller volume of credits are obtained due to lower emission reduction than expected or more costs are incurred in the project implementation than expected. In such cases, an issue of unfair trade practices (abuse of superior bargaining position) could arise in relation to the Antimonopoly Act if enterprises in a superior bargaining position¹¹, unjustly in light of normal business practices, induce their trading partners to bear these additional costs or to accept decreases in profits.

3.2.3 *Conduct regarding loan projects, etc.*

32. As financial institutions are participating in the trading of emission allowances and external credits in the experimental implementation of an integrated domestic market for emission trading, it is also anticipated that they will also participate in the future emission trading as the sellers of emission allowances and external credits.

¹¹ Business enterprises that purchase external credits are in many cases large scale enterprises as a consequence of participating in voluntary action plans. As enterprises engaged in emission reduction in the external credit project are, on the other hand, mainly presumably small and medium-sized enterprises which do not participate in such plans, it is highly likely that the former is in a superior bargaining position over the latter.

33. In such a case, an issue of unfair trade practices (tie-in sales, etc.) could arise in relation to the Antimonopoly Act if a financial institution requests its borrowers to purchase emission allowances or external credits from either itself or its subsidiaries in providing credits and virtually forces them to accept the request.

34. In particular, it could be an issue of unfair trade practices (abuse of superior bargaining position) in relation to the Antimonopoly Act if financial institutions, etc., in a superior bargaining position with a continuous business relationship such as loans, etc., as a backdrop, unjustly induce loan recipients to purchase emission allowances or external credits whose prices have declined.