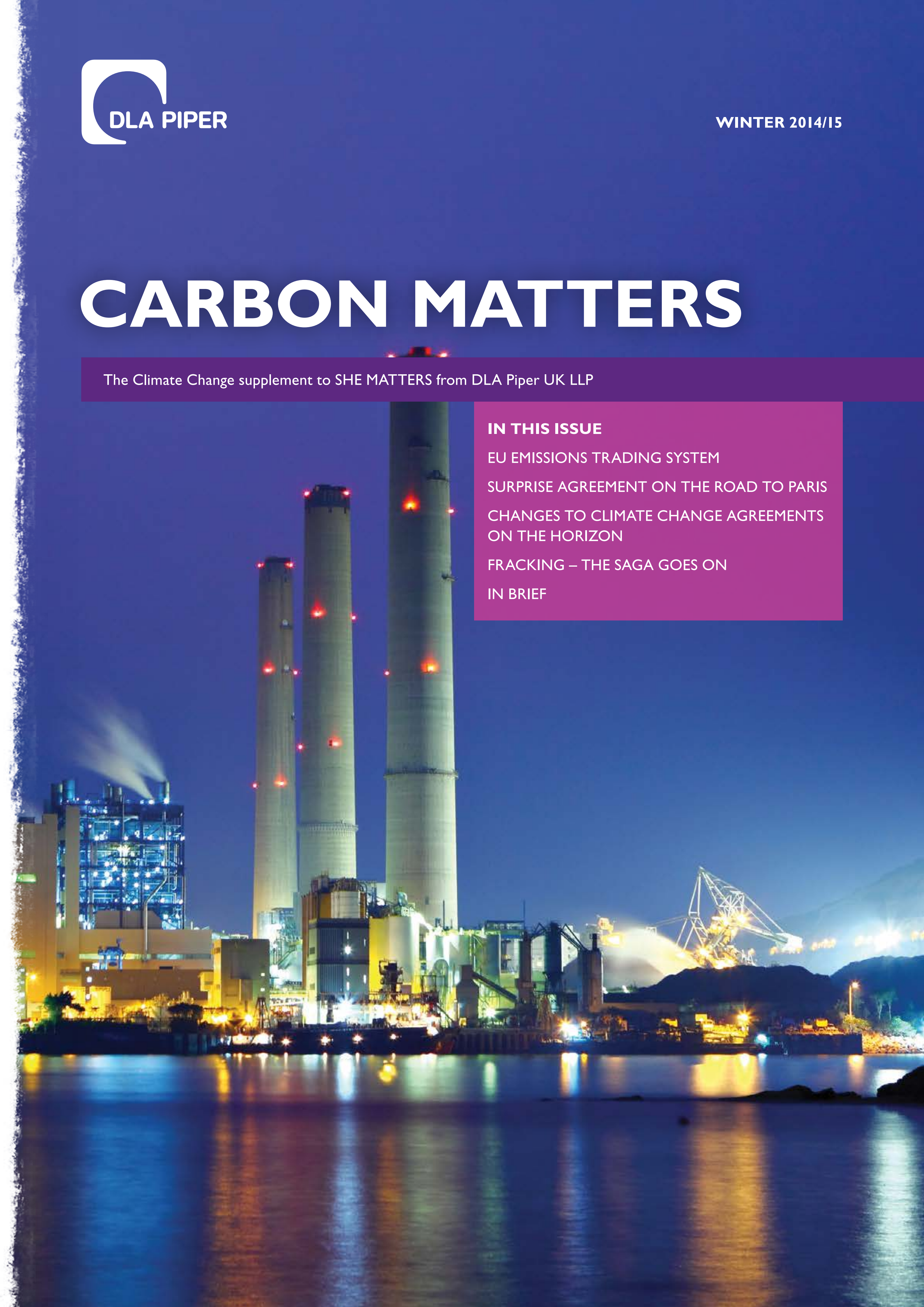

DLA PIPER

WINTER 2014/15

CARBON MATTERS

The Climate Change supplement to SHE MATTERS from DLA Piper UK LLP

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CARBON MATTERS

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This edition of Carbon Matters was going to press just after the close of the 20th session of the Conference of the Parties to the UNFCCC in Lima. The task of the conference was to prepare for the Paris COPMOP at the end of next year. In particular, the states represented at the Conference needed to reach agreement on a common framework, with specified categories of required "upfront information" for the intended targets, known as "Intended Nationally Determined Contributions" (**"INDCs"**), to be submitted by Parties in the first quarter of next year in advance of the Paris COPMOP.

The Conference got under way under some controversy. A press release from the World Meteorological Organisation issued shortly before the conference claiming that 2014 was set to be the warmest year on record, was criticised as a politically motivated call for action at Lima with a questionable basis in statistics. There was also sniping at the predicted carbon footprint for the conference, expected to be the largest at any UNFCCC meeting to date.

However there was a general mood of optimism in advance of the Conference, owing to the China US agreement on emissions reductions, announced in March and confirmed by a subsequent declaration in November and to the October declaration by the European Union of its intention to reduce greenhouse gas emissions by at least 40% below 1990 levels by 2030.

The Conference listened to an emphatic speech by the US Secretary of State John Kerry which made it clear that the current US administration considered action on climate change to be a matter of the highest priority.

The optimism dissolved fairly rapidly in disagreements, and the conference had to overrun in order for an agreement to be reached. Nevertheless, an agreement was reached, with compromises on auditing and the information on how Parties propose to meet their targets, and a promise on financial help for adaptation by poorer countries. The resulting agreement has been criticised as too weak by some environmentalist NGOs.

Such NGOs, and in due course EU negotiators preparing for the Paris COPMOP, might do well to bear in mind a key lesson of the Copenhagen COPMOP. This is that the best can be the enemy of the good. It may be better to accept what is offered by top emitting nations, than to press for something they are not prepared to agree to. It may therefore be appropriate to be flexible on issues such as whether or not an agreement at Paris should be legally binding. In the end what is actually delivered in terms of emissions reductions is more important than whether or not the parties are legally committed. If they deliver, all well and good. If not, there is very little that courts or lawyers can do to make them deliver. For that reason also, it was probably sensible to make compromises in Lima.

EU EMISSIONS **TRADING SYSTEM**

Reactions to the European Commission's proposal for a new Market Stability Reserve

The Government has recently set out its policy position in respect of the EU Commission's proposal to introduce a new Market Stability Reserve for the EU Emissions Trading System (**"EU ETS"**) published in January 2014 as part of the EU 2030 framework for climate and energy policy.

In the Autumn 2014 number of Carbon Matters, we considered the reasons behind the proposal for a market stability reserve – broadly, to address the issues of surplus EU ETS allowances and resulting weak carbon price signal. We saw that the aim of the reserve is to create a more balanced market, with the ability to adjust supply to meet fluctuations in demand due to events such as unforeseen changes in economic forces.

The reserve would see allowances being released and added to future auctions only where the total surplus is fewer than 400m allowances, while at the other end of the scale, allowances would be deducted from future auctions only where there the total surplus is higher than 833m allowances. Working alongside the reserve, the Commission also intends to introduce "backloading", whereby the auctioning of 900m allowances would be postponed between 2014 and 2016, not to be reallocated until 2019-20.

In this issue we consider the policy position primarily of the UK but also of other EU Member States and industry groups regarding the Commission's proposals. These policy positions are significant since they are an indication of the input these stakeholders are likely to have on shaping the final proposal and informing the Commission's final decision in this area.

In principle, the UK supports the market stability reserve, however it is in favour of a stronger approach. The Government has suggested that implementation be brought forward to 2017, part-way through Phase III of the System which started in 2013 and ends in 2020, instead of from the start of Phase IV in 2021 as proposed by the Commission. In relation to backloading, it has suggested that either the backloaded allowances should be cancelled entirely or in the alternative that they are placed directly in the reserve.

The Government also raises concerns that the Commission's proposed smoothing mechanism will not be sufficient to prevent a flood of allowances into and then out of the market between 2019 and the mid-2020s, resulting in fluctuating prices, increased uncertainty for industry and decreased investment activity. This is precisely the opposite of the Commission's goal of achieving a stable development of supply and prices over the coming decades. Overall, the Government favours the approach of cancelling the backloaded allowances entirely, in the hope that this will avoid the undesirable effects mentioned above.

The Government has also proposed that the rules allowing for return of allowances in the reserve to the market are tightened in order to ensure they are only released when the market is under pressure. To address this, the Government has suggested that either the surplus threshold is reduced to below 400 million, or to return allowances only when both price rises and surplus thresholds are met simultaneously.

Germany and the Confederation of British Industry (**"CBI"**) have both provided viewpoints that are very similar to that of the UK, although CBI regards 2021 as a suitable long-stop deadline for implementation rather than pushing for early implementation as the UK has done. However CBI has criticised the Commission's proposals for lack of transparency and detail, for example its failure to provide information about the analysis surrounding the decision-making process and to consider possible alternatives to ensure that companies achieve the certainty they require. Finally CBI also raises questions about the reserve's ability to respond to changes in demand with sufficient rapidity.

By contrast, some EU Member States oppose entirely the early introduction of the market stability reserve. Industry group Business Europ also opposes the move, saying that it should not be adopted before the Commission has issued proposals to ensure that industries will not be affected by competition from industries in countries with fewer environmental regulations. If the Commission's proposals receive support, the likely effect of this on companies is increased liability in terms of the cost of allowances, however certainty for business is also likely to increase due to the stabilising effect of the proposals on the market price for carbon.

The discourse surrounding the market stability reserve has also reawakened concerns surrounding carbon leakage, with CBI in particular commenting that the Commission should be more clear on how the reserve will interact with support for businesses in this area.

After lengthy negotiations European leaders recently unanimously approved parts of the Commission's 2030 climate and energy package. There was little detail revealed about structural reforms to the EU ETS. A Market Stability Reserve was mentioned though and it is clear that the views of European leaders will be extremely influential in determining the final form of the Decision. By way of next steps in the legislative process, a first reading and vote in committee is scheduled for February 2014.

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SURPRISE AGREEMENT ON THE ROAD TO PARIS

For years the possibility of truly effective global action on climate change has been little more than a pipe dream. To a large extent, this has been down to the lack of participation from the world's biggest polluters, the US and China. On 12 March a potentially historic bilateral agreement was made between the US and China which could signal the most significant change in climate change discussions in the last quarter of a century.

THE AGREEMENT

China has agreed to ensure its CO_2 emissions peak by 2030 and decrease its reliance on fossil fuels so that by 2030, 20% of its primary energy consumption is fuelled by renewable sources. Many have criticised the fact that China does not have to cap emissions until 2030. However in order to achieve a cap, China will have to take immediate action to curb its reliance on fossil fuels. Furthermore, with ever increasing levels of pollution drastically affecting public health China, it would seem that this agreement is far from just an act of political goodwill.

The US have agreed to reduce emission levels by 26-28% from 2005 rates by 2025. This adds to their previously agreed reductions which were to be in the range of 17% by 2020 and 83% by 2050. In order to reach this new target the US will have to take aggressive action of the style suggested in President Obama's Climate Action Plan. Whilst the stand alone targets in this agreement are not going to solve the climate change crisis on their own, we think that the wider implications of this agreement certainly do present cause for hope.

The importance of the agreement

1. Big players, big change in direction

   Depending on which statistics are used, the US and China together account for between one third and forty per cent of the world's greenhouse gas emissions Whilst this is important in terms of the likelihood of global reduction targets being achieved, it is arguably even more important when you consider the political impact that these two nations have on the global stage and the wider potential repercussions of their decisions on climate change.

For a long time both nations have failed to act in fear that if they do the other will not and that this will result in an economic disadvantage. The knock-on effect of this standoff has been wide-ranging and has contributed to a reluctance from other heavily polluting nations to reduce emissions, as well as being partly responsible for the failure to agree effective targets at Copenhagen in 2009. The big change in approaches from these two countries has raised hopes that other nations will follow suit and that consequently effective targets might be agreed at Paris next year (see further discussion below).

2. Rhetoric with a future

   The language of the Chinese targets includes the wording "… or earlier …". This tentative openness to improved rates of reduction is similar in style to the wording in the latest EU targets which includes the words "… at least …". Whilst some will dismiss this as mere rhetoric, with Paris 2015 just around the corner, and given China's previous reluctance to agree to anything, we suggest that this wording leaves the door open to future negotiation, even if at the moment the door is only left slightly ajar.

   Few will deny that the agreed targets are far from ideal and the obligations, at least on the face of it, have no immediate bite. This could lead you to dismiss this agreement as political rhetoric, however we think that the importance of the agreement is not so much in the figures as it is the sentiment behind them. Therefore, even if the agreement is to be considered to be only rhetoric, we would argue that it is rhetoric with a future.

3. Paving the road to Paris

   In his speech to mark the agreement, the Chinese premier Xi Jingping stated that the US and China had agreed to *"make sure international climate change negotiations will reach agreement as scheduled at the Paris conference in 2015"*. With agreement to lower emissions from the US, China and the EU in well before the March deadline, hope for an effective Paris meeting is running high.

   Furthermore, this agreement poses the question to the other large polluting nations such as Australia, Canada, India, Russia, Japan and Brazil, "what are you going to do?" As a number of commentators have pointed out, we are a long way off celebration just yet, but for the moment, no-one can deny the existence of the all-crucial political impetus the agreement has created and which has been crucially missing at previous meetings.

The folly of a figurehead?

With the Democrats losing control of the US Senate some are questioning whether President Obama's actions are a desperate last attempt to make an impact with the ever dwindling power he still has. This we will perhaps never know. However, what we do know is that the political situation in America has the potential to essentially nullify the importance of this agreement.

Senator McConnel (the soon to be incumbent majority leader of the Senate) and long-time climate change denier Senator Inhofe (soon to be incumbent chairman of the Senate Environment and Public Works Committee) have furiously attacked this agreement and have publically stated that they will do all in their power to stop President Obama committing the US to the agreed limits.

They have already intimated that they want to curb the power of the Environment Protection Agency and are currently working on ways of preventing the President using his executive powers to force the issue. The problem they face, however, is that their key potential argument (the US can do nothing whilst China does nothing) has lost credibility overnight. Regardless of whether this affects the Republican attacks on this agreement, it will certainly be interesting to see how it affects US climate change discourse going forwards.

Conclusion

This agreement certainly provides cause for hope. Whilst the targets are not ideal, their importance is marginal in comparison to the major political shift that this agreement represents. With China in a health crisis, President Obama threatening to use executive powers and the US-China standoff finally ended, political momentum for effective agreement is arguably at an all-time high and we now await Paris 2015 with new excitement. The threat that the Republican party in the US poses is significant and should not be underestimated. However even if their action halts progress in the short term, it is hoped that regardless, the wider implications that have been talked about should have an effect beyond this agreement.

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CHANGES TO CLIMATE CHANGE AGREEMENTS ON THE HORIZON

THE 2016 REVIEW OF ENERGY EFFICIENCY TARGETS

Climate Change Agreements (**"CCA"**) are voluntary agreements for energy intensive businesses that require certain energy efficiency targets to be met. In return, participants receive a discount from the main climate change levy (**"CCL"**) rate. The current reductions are 90% in respect of electricity costs and a 65% reduction in respect of gas costs.

The measurement and reporting of energy usage is done over "target periods" which each last two years. The CCA Administration Regulations 2012 specify four two-year target periods for the period 2013-2020 and the targets for these periods were agreed following a consultation in 2012. The Government's response to the consultation stated that a review of targets would be carried out in 2016 to ensure that *"targets are challenging but achievable for operators"*.

In October 2014, the Department for Energy and Climate Change (**"DECC"**) published a discussion paper to set out the proposed approach to the target review and to receive industry feedback.

The proposal is to split the review into four stages:

1. A high level review of all sectors in the scheme to identify areas where changes may have occurred since targets were set;
2. A follow on detailed review;
3. Agreeing new sector level commitments with industry associations; and
4. Cascading revised sector commitments to inform revised targets.

Responses to the consultation are due by 23 January 2015.

Many of the large industries have the benefit of exemptions from the CCL including, for example, those falling under the recently implemented mineralogical and metallurgical exemption. Sectors who produce products such as steel, glass, cement and ceramics will find that the energy use for major parts of their processes are therefore exempt from the levy. This recent change was introduced to bring the UK in line with the rest of Europe as concerns were being raised that the UK tax was unfairly prejudicing energy intensive industries.

Whilst the introduction of this exemption may have levelled the playing field with Europe, there is now a wider concern that such sectors have little financial incentive to meet their CCA targets. Comments from sector association heads for manufacturers and those in the ceramics sector confirm that whilst some see the CCL savings as a benefit others are less won over as they see no financial benefit. There is, of course, an element of selling membership of a CCA as part of a company's green credentials.

Messages from sector associations are mixed, and it will be interesting to see how the consultation on reviewing targets is received and importantly, what this means for the future of CCAs in those sectors that benefit from an exemption from the CCL.

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FRACKING
THE SAGA GOES ON

It was recently announced that Ineos, the owner of the Grangemouth Refining Site, has acquired two shale gas exploration licences in Scotland, covering more than 120,000 acres, and has also submitted a significant number of bids, mostly relating to the North of England, in the UK Government's latest onshore oil and gas exploration licensing round.

The company's aim would be to use the gas to provide a cheap source of fuel and feedstock for its operations at Grangemouth to help improve its completion position internationally and also to sell gas for commercial and industrial use.

The fact that a significant proportion of the company's operations are planned to be in the Central Belt of Scotland, might set the company on a collision course with the Scottish Executive. This is because the company will wish to take advantage of the new legislation which the UK government is planning to introduce to provide for compulsory access rights to underground land at depth for operators carrying out gas or oil extraction operations or geothermal energy projects. As mentioned in the previous edition of Carbon Matters, the Scottish Executive has been a prominent opponent of these proposals.

It was not alone in this. Following the conclusion of the Consultation, DECC published towards the end of September the Government response to. This revealed that more than 99% of all respondent opposed the proposals, an unusually high negative response rate. It should however be mentioned that a high proportion of the respondents did not address what the Government considered to be the issues relevant to the Consultation, and many responded using either or both of two standard prepared campaign texts.

What will perhaps be of interest is to see whether the Scottish Executive now moderates its opposition to fracking for shale gas. One of the very recent recommendations of the Smith Commission is that the licensing of onshore oil and gas extraction will be devolved to Edinburgh as regards both legislative and executive aspects. (Offshore oil and gas extraction will remain a reserved matter). Similarly, responsibility for underground mineral access rights for onshore extraction of oil and gas will also be devolved.

There will be a further wide-reaching devolution in respect of Crown minimal rights, subject to there being a Memorandum of Undertaking to ensure that devolution in respect of these matters is not detrimental to UK-wide national infrastructure in relation to oil gas and energy.

It may well be that with the new powers in its hands, but also the corresponding responsibility to ensure that key economic assets such as Grangemouth do not stagnate, the SNP administration will see new virtues in shale gas operations.

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IN BRIEF

DLA Piper has been involved in litigation relating to the allocation of allowances under the European Union's Emissions Trading System (**"EU ETS"**).

On 31 October 2014 the Administrative Court in London granted permission for an application to be made by operators subject to the EU ETS for judicial review of the national implementing measures giving effect to a Commission Decision in the allocation of allowances. DLA Piper is representing two of the operators concerned. Similar legal challenges have been mounted in a number of other EU jurisdictions.
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