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Environment Legal Alert

Implementing the EU's Climate Change and Energy Package

In December 2008, the European Council adopted its wide-ranging Climate Change and Energy package. Central to the package is the EU's headline 20-20-20 targets on cutting greenhouse gas emissions, increasing renewable energy and boosting energy efficiency, based on 1990 levels.

Although the 20-20-20 targets – originally proposed by the EU Commission in more benign economic times – have survived, agreement at the European Council on these targets was only possible with some significant concessions to Member States. In addition, the EU has retained its commitment to increase its greenhouse gas reduction target to 30% in the event of a successful international negotiation on a post-Kyoto treaty.

Some of the detailed legislation aimed at achieving the targets has already been settled: in particular, the text of a Directive on promoting renewable energy, a Directive on fuel quality and a Directive on CO_2. The latest round of legislation expected to be adopted imminently is:

- a Directive revising the current EU Emissions Trading Scheme (ETS);
- a Decision on effort-sharing; and
- a Directive on carbon capture and storage ("CCS").

These measures will have considerable implications for business across the EU and in this Alert we highlight some of their main provisions.

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Background

The 20 percent target for reducing greenhouse gas emissions is to be achieved in two ways: a 21% reduction in emissions covered by the ETS (compared to 2005) by 2020 and a reduction of around 10% compared to 2005 for sectors that are not covered by the ETS (after the amendments referred to below came into effect). Taken together, this is equivalent to a reduction of 20% compared to 1990 levels. Non-ETS sectors covered by the 10% target include: transport, buildings, smaller industrial installations, agriculture and waste.

Directive revising the EU Emissions Trading Scheme

The ETS is the EU's main instrument for reducing greenhouse gas emissions. It covers over 10,000 installations accounting for almost half of the EU's CO_2 emissions. To date, the ETS has been limited to large energy combustion plants, oil refineries, pulp and paper plants, cement, steel, glass and ceramics manufacture. From 2013, the ETS:-

- extends the sectors (and gases) to be covered by the scheme;
- extends the requirement to auction allowances (rather than allowing the free allocation of allowances). Following pressure from eastern European countries and Germany and Italy, the original proposals have been somewhat watered down. The adopted position introduces the following caveats:
  - first, an optional and temporary derogation will be available to poorer Member States more heavily reliant on single fossil fuel production. This was particularly to take account of the fact that over 90% of Poland's electricity is based on coal-fired generation;
  - secondly, certain sectors deemed to be at significant risk of "carbon leakage" (i.e. possible relocation to third countries with less onerous carbon laws) will receive a proportion of free allowances. The list of relevant sectors is to be published by the Commission by 31 December 2009; and
  - thirdly, the level of auctioning will be introduced gradually by 2020;
- will include a solidarity fund which will use some of the revenue from auctioned allowances to assist Member States (especially poorer Member States) move towards lower carbon technologies.

Decision on effort sharing

Although the measures to be taken in non-ETS sectors to reduce emissions are largely left to individual Member States, the purpose of the Directive on effort-sharing is to allocate each Member State specific reduction targets for non-ETS emissions reductions which will average out at 10%. The targets apply from 2013 to 2020.

Whilst, in the coming years, poorer Member States will be allowed to increase their non-ETS emissions others must achieve a reduction of up to 20 percent. For the UK, the target is 16%. The targets will be translated into annual binding targets on Member States, although several measures have been incorporated to give flexibility to Member States including the ability to bank and borrow emission budgets between years (5% max); the ability to transfer over-achievements between Member States and carry out projects in other Member States.

In addition – and most critically for those involved in carbon trading – credits under the Clean Development Mechanism ("CDM") or Joint Implementation ("JI") can be used for compliance with these targets up to a maximum of 3% of 2005 emissions.[1]

Directive on Carbon Capture & Storage

Critical to tackling CO_2 emissions is the EU's approach to coal-fired power generation. Emissions from coal-fired plant are already covered by the ETS, but with about a third of existing coal-fired capacity in the EU due to be replaced within the next 10 years, there is an opportunity for further cuts in CO_2 emissions if new plant is built with CCS.

The issue is timing: the EU only expects the uptake of CCS on a commercial scale from around 2020. This is because although the technologies of capture, transport and storage of CO_2 have all been demonstrated individually, integrating them into a complete CCS process and bringing down the costs remains a challenge. At current prices, up-front technology costs are between 30% and 70% greater than for standard plants. Despite the uncertainties around CSS, consents are already being issued for new coal-fired plant in the EU. The Directive on CCS attempts to deal with those issues in a number of ways.

First, although CCS will not (at this stage) be mandatory from any given point in time, applicants for permits to construct any combustion plant of 300MW or more must, from the date of entry into force of the Directive, carry out an assessment of whether it is technically and economically feasible to retrofit CCS, whether there are suitable CO_2 storage sites and whether transportation to such sites is economically and technically feasible. If so, suitable space for CCS equipment needs to be set aside.

CO_2 captured and safely stored under CCS will be regarded as not emitted for the purpose of the ETS.

Long-term responsibility for geological storage is also a key concern for business. Plainly storage will extend over much longer periods than the lifespan of a typical commercial entity. So, the Directive provides for sites to be transferred to Member States' control once the site no longer represents risk of significant CO_2 leakage and subject to a financial contribution from the operator covering (at least) monitoring costs for 30 years.

1 This limit is increased by an additional 1% for some Member States in certain circumstances.

Finally, with a view to **incentivising** CCS demonstration projects, the amended ETS envisages that Member States should use at least 50% of their auctioned allowances to finance certain projects including CCS **demonstration** projects. In addition up to 300m allowances in the EU new entrants' reserve will be made available for up to 12 CCS demonstration projects.

Conclusion

The real story with the climate change and energy package is that whilst the headline targets have been retained, many Member States are worried about the costs of compliance. This has resulted in some significant paring back of the original proposals. As mentioned above, this is particularly true when it comes to the provisions on auctioning allowances under the ETS. The original plan of requiring 100% auctioning has not come to pass. Power generators in some countries may only have to buy about 30% of allowances in 2013. Outside the power sector industrial plants covered by the ETS will only have to buy 20% of their allowances at auction 2013 rising to 70% in 2020.

That, in turn, means that revenues from auctioning which are to be put into CCS and renewables projects will be adversely affected.

On the plus side, the carbon trading market gets a boost from these proposals: sectors covered by the ETS can meet up to 50% of their reduction efforts by buying CDM or JI credits and in non-ETS sectors, Member States can meet their reduction targets by up to 3% (or more in the case of some countries, not including the UK) by buying CDM or JI credits.

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