TRAVERS SMITH

# 2009 Climate Crunch Time

The UK's 80% legal emission reduction target will be stretching and have major implications for all sectors of the economy. Business will need to start to address these now despite the economic downturn, providing both opportunities and challenges.

This note summarises the key provisions of the landmark Climate Change Act 2008, the *Brussels* Summit that sets the parameters for the new EU Climate Change Package and considers the outcome of the UN Climate Change conference at *Poznan*.

In particular, if you are one of the 5000 organisations likely to be caught by the proposed Carbon Reduction Commitment, mandatory emission monitoring, reporting, auctioning and trading are likely to require prompt attention. For other companies, measuring and reporting will soon become mandatory.

## *The International Stage – Post Kyoto Deal*

As the ink dries on the deals reached on 12 December at the global UN Climate Change conference at *Poznan* and the EU *Brussels* Summit, international and EU climate change strategy respectively stutters onwards, leaving business grappling with somewhat mixed messages.

Little real progress was made in *Poznan* but the next UN conference in Copenhagen next year is the real deadline for agreement on what happens when the Kyoto Protocol ends in 2012. Negotiators are clearly playing a long game, with their negotiating positions for the next UN conference in Copenhagen in December 2009 firmly in mind. *Poznan* does at least set out a timetable and a skeleton framework for a global agreement at Copenhagen. Given the heat of debate on the range of issues that remain to be agreed at Copenhagen this is not altogether surprising. These issues include the involvement of the US, China, India, avoided deforestation, aviation and critically the level of financial support for technology transfer to developing countries. The credit crunch and change in US president provide additional uncertainty.

## *UK Takes the Lead*

Meanwhile, back at the ranch on 26 November, the UK Parliament passed the landmark Climate Change Act 2008 *(“**CCA**”)* into law, sending a strong message to the international community that the UK is committed to becoming a low carbon economy and decoupling productivity and consumption patterns from greenhouse gas *("GHG")* emissions.

With its bold headline – a statutory target demanding an 80% reduction in relevant emissions by 2050 - the CCA will have a clear impact on UK PLC in the long term capital investment programmes, and will require significant effort from all sectors.

As a framework Act, the CCA will ensure that few corners of the economy are untouched, although significant details remain to be clarified in secondary legislation. The proposed CRC, for example, is subject to one final round of consultation on draft Regulations due to be published in February 2009.

> *Even if the international community decides not to deliver similarly challenging targets it will be hard but not impossible for the UK to pull back from these targets.*

> *"Ministers have estimated that seeking to improve the country's environmental performance, and generate 15 per cent of energy from renewables by 2020, would generate 160,000 new jobs."*
> FT, Sunday Nov 16 2008

## *Brussels Summit - The EU Climate Change Package*

European leaders claim the 20:20:20 commitment will cost billions but deliver a low carbon future for Europe and show leadership that will help deliver a collaborative front with US president elect Obama as the international community strives for a global deal. The package is not without its critics who argue that on the one hand, too many concessions were won in lobbying and on the other, that it will cost too much and will leave the EU competitively exposed encouraging 'carbon leakage' whereby EU industry relocates to countries with less stringent GHG emission targets and policies. Four major pieces of legislation comprising the Climate Change Package were passed by the European Parliament on 17 December. Key aspects of the package include:

- 20% cut in GHG emissions by 2020, against 1990 levels, but rising to 30% if an international deal is reached in Copenhagen
- 20% increase in use of renewable energy by 2020
- 20% cut in energy consumption through improved energy efficiency by 2020
- 19% increase in efficiency of cars
- support for sustainable biofuels and carbon capture and storage

- concessions for some heavy industry steel, cement and coal fired power stations
- a new burden sharing agreement to reflect the different starting points between the member states
- support for international carbon projects to enable GHG offsetting projects (like those under the Kyoto Clean Development Mechanism *("**CDM**")*) to be delivered overseas to count towards the emission reduction targets.

## Climate Change Act 2008

The CCA received Royal Assent on 26 November 2008. It is the first legislation of its kind globally to provide a long term legally binding framework to tackle climate change.

The main provisions of the CCA relate to setting targets for reducing the emissions of the six Kyoto GHG (carbon dioxide, methane, nitrous oxide, HFC, PFC and SF6) and any other gases added later by the Secretary of State by at least 80% by 2050, and at least 26% by 2020, as against a 1990 baseline for the first three gases and a 1995 baseline for the latter three. This translates to a 77% reduction from current levels by 2050.

> *This stretching target accords with a shift in scientific consensus on the steps required to keep committed warming to 2 °C and keep the risk of a change of 4°C at a "very low" level. It is broadly agreed that a 2°C increase is practically unavoidable and that a failure to avoid a 4°C increase would have catastrophic consequences on human welfare and the broader environment.*

In broad terms, the independent Climate Change Committee established by the CCA (the "***CCC***") said global effort was required to reduce global GHG emissions by 50% by 2050, from 45 giga-tons today to 20/24 giga-tons. Taking a "fair share" for the UK and accounting for population growth and development requirements and other factors, a target of 80% was deemed reasonable for the UK. Referring to analysis in the Stern Review, the CCC suggest that the costs of failure is expected to be significantly higher than the cost of addressing the issue now.

As part of the national climate change strategy, the EU Emissions Trading Scheme *("**EU-ETS**")* aims to motivate the energy intensive sectors to reduce their GHG emissions, but the CCA reflects the fact that significant effort will also be required from all other sectors.

The key measures provided for in the CCA include:

- decarbonisation in the supply of electricity (with support for renewable technologies, new nuclear and carbon capture and storage to permanently remove emissions generated by fossil fuel power plants)
- cleaner surface transport such as electric and hybrid cars and vans and the use of biofuels
- energy efficiency measures in the built environment and encouraging realistic behavioural changes
- encouraging greater energy efficiency and emission reductions through new mandatory cap and trade schemes, including the Carbon Reduction Commitment, discussed in more detail below
- mandatory corporate reporting obligations
- paving the way for a proportion of international aviation and shipping emissions to be regarded as UK emissions.

### *Committee on Climate Change and Carbon Budgets*

The CCC advises the Government on issues relating to the target reductions and budget, the relative contribution of domestic and international reductions, and which sectors of the economy the targets should focus on. The CCC will report annually to Parliament on the UK's progress. The first report was published on 1 December 2008 and the Government will be required to respond to the annual progress reports.

The emission reductions are to be achieved by the setting of five-year carbon budgets, which will set binding limits on GHG emissions for the UK, imposing a new statutory duty on Government. Three successive budgets will always be current to give business and investors some long-term certainty for decisions on capital allocation. The CCC has already published its suggestions for the UK's first three carbon budgets (for the

> *"Meeting this target should cost 1% of GDP by 2020 and 1-2% GDP by 2050."*
> Lord Turner, Climate Change Committee

period 2008-2022) which will be set alongside the (economic) Budget 2009.

Whilst the CCA has set a 26% reduction target to be reached by 2020 the CCC recommended that the UK should accept a tougher target of a 34% reduction as a minimum, rising to at least 42% from 1990 levels if an international agreement is reached by the end of 2010.

In the 2008 Pre-Budget Report, the Chancellor announced that a final report setting out its policies and proposals to meet the carbon budgets required under the CCA will be laid before Parliament in mid-2009.

The CCC has also stated that new coal-fired power stations should only be built with the clear expectation and certainty of retrofitting carbon capture and storage in the early 2020s.

### *Legal basis*

The limits set are legally binding and technically the Government will be in breach of the statutory duty in the CCA should it fail to deliver. Whilst the CCA does not impose direct sanctions for such breach, the NGO community and media will be watching closely. Parliament is required to respond publicly to the CCC proposals and will be under pressure to justify any variance.

### *Offsetting*

The UK will be able to net off from the annual carbon account (and so count as a reduction towards the budget) certain approved carbon reduction credits procured from emission trading markets. These will principally include Certified Emission Reductions ("***CERs***") from international CDM projects and allowances purchased from other countries from within the capped EU-ETS.

Offsetting is seen by some commentators as a controversial loophole permitting reduced domestic efforts, and encouraging "cheaper" efforts overseas. This is defended by others on the basis that rigour is embedded in those trading systems and in climate change terms, it does not matter from where geographically GHG emissions are reduced, globally the impact is the same. The CCA demands

that limits are set in consultation with the CCC. Under the new EU package, up to half of a member state's reductions can be delivered in this manner.

> *"This is both a challenge and an opportunity and those that are most adept at adapting to an ever more carbon constrained world will gain a first mover advantage…Not only is a shift to a low carbon economy essential if we are to combat climate change but it also makes good economic sense to improve our energy efficiency and increase our energy security by reducing oil and gas imports."*
> Stavros Dimas, Commissioner responsible for environment, 24 November 2008

*Carbon Reduction Commitment ("CRC")*

The CRC is a proposed UK-wide mandatory emissions trading scheme for the non-energy intensive sector. The Government has consulted widely on its structure since November 2006 and a user guide for potential participants and the final consultation on the Regulations will be published by DEFRA in February 2009.

It is a "cap and trade" scheme meaning it aims to both keep the total GHG emissions below a government-set maximum level ("*the cap*") and increase energy efficiency through time by obliging participants in the scheme to sell or buy "allowances" representing the right to emit a certain amount of GHG ("*the trade*") up to the level of their cap. The less GHG emitted the fewer allowances the participants will need to purchase.

From April 2010 any *"organisation"* that in the *"Qualification Period"* between 1 January and 31 December 2008 used over 6,000 MWh of electricity as measured by half-hourly meters will be subject to the CRC. This means that any organisation that spends roughly £500,000 or more on electricity is likely to be subject to the CRC. This is likely to catch 5000 organisations responsible for around 10% of total UK C02 emissions.

Registration will take place between 1 April 2010 and 30 September 2010. Participants will need to monitor all energy sources (not just electricity) during the first year of the CRC (April 2010-March 2011), the 'Footprint Year', and use this data to prepare a Footprint Report for submission in July 2011.

The scheme will run on a financial year with the first allowances sold at a fixed price of £12/tCO2 in April 2011 to cover both 2010 and 2011 emissions. Reporting and surrender of allowances will occur at the end of July. For all subsequent years participants will not be able to purchase allowances in a given year to cover the previous year's emissions. Auctioning of allowances will begin in 2013. The Government intends to recycle the money raised from the allowance auction back to participants six months after each year's auction proportional to 2010/2011 emissions with a bonus or penalty depending on a participating companies position in a public league table.

> *"Climate change will affect the basic elements of life for people around the world – access to water, food production, health, and the environment. Hundreds of millions of people could suffer hunger, water shortages and coastal flooding as the world warms"*
> Sir Nicholas Stern, The Stern Review, October 2006

*Who is caught*

Private and Public sector organisations alike will be caught. Where organisations are part of a group of companies (using modified Companies Act 2006 definitions of parent and subsidiary undertakings) it is the group as a whole which is assessed, not each individual member of the group. Responsibility for participating in the CRC will be on the UK parent organisation. Only members of the group whose operations are in the UK will be considered (but separate UK businesses owned by a single foreign parent will be combined as a single organisation for CRC purposes).

For private equity, venture capitalists and other investor groups, all equity investments of over 50% will count for qualification and compliance purposes.

This is a novel departure for private equity companies who will find themselves measuring and managing energy from investee companies who would otherwise fall under the emissions trading radar. Whether this effect of the CRC will be included in the final drafting of the Regulations remains to be seen.

There will also be implications for companies buying or selling subsidiaries and properties who will need to factor the CRC implications into their due diligence. Any energy used by a Joint Venture will count towards the majority shareholder's calculations but 50:50 JVs or those with no majority owner will be treated as stand-alone entities.

Landlords may be caught by the CRC and be required to purchase allowances. Whether such costs can be passed on to tenants will depend on the terms of the lease. Landlords may be able to claim that the 'cost of electricity' is sufficiently wide to cover the cost of buying allowances but is unlikely to justify recovery of associated administrative costs. If landlords can pass on the cost of allowances, and subsequently recover a proportion at the end of the year there will need to be contractual arrangement for the tenants to recover a fair share of this recovered sum.

***What to do now:***

- *Organisations which fall within the definition of "organisations" for the purposes of the CRC may wish to challenge this in the consultation in February*
- *Companies, partnerships and investor groups should collate all electricity usage figures on a group basis to determine whether they exceed the 6,000MWh threshold*
- *Companies currently below the threshold, but engaging in acquisitions in the future, should be aware that such acquisitions could bring them within the scope of the CRC*
- *Landlords with a portfolio of properties will also need to consider how costs and payments are to be divided up between those buildings. Landlords and tenants may wish to consider 'green lease' provisions in respect of energy consumption and responsibility for CRC payments*
- *Private Equity and Venture Capital houses may need to implement some novel systems to manage investee company involvement*

*Mandatory Reporting Obligations*

By 6 April 2012 the Secretary of State must make regulations under the Companies Act 2006 requiring directors annual reports to contain information about GHG emissions from the company.

In the meantime, under section 62 CCA, the Secretary of State has the power to require public authorities and statutory undertakers (companies like water and energy utilities) referred to as 'Reporting Authorities' to report on how their organisation is assessing and acting on the risks and opportunities of climate change and their adaptation strategy. Once a report has been produced, an organisation will have a duty to regard that report in its ongoing operations. In summer 2009 the Government will consult on statutory guidance to be published for organisations on assessing the risks from climate change and drawing up adaption plans.

***What to do now:***

- *Although there is no immediate requirement to disclose GHG emissions, companies who have not already begun considering the calculation of their carbon footprint will need to consider doing so.*
- *Organisations which fall within the definition of Reporting Authorities for the purposes of the CCA may wish to respond to the consultation on the statutory guidance.*

> *Travers Smith has "…a growing stand-alone practice including climate change, renewable energy and major projects..."*
> Practical Law Company - Cross-Border Environment Handbook 2009

# TRAVERS SMITH

## A leading Climate Change and Renewable Energy Practice

Increasingly, greenhouse gas emissions are a priority consideration in many businesses' operations. We are helping our clients to successfully manage commercial risks and seize new business opportunities in this area.

The greater emphasis on meeting the challenges of climate change has led to renewable energy, clean technology and emissions trading becoming key issues for many clients. We have a multi-disciplinary team which advises in these areas, bringing together specialist lawyers from the firm's environmental, funds, corporate finance, private equity, commercial real estate and tax practices.

## A full service team

We are dedicated to finding solutions, always practical, often innovative, to the challenges our clients face. Our team's experience covers all aspects of climate change-related advice. We have advised clients on:

- The assessment of and investment in renewable energy and climate change projects, including private equity investments and IPOs
- developing renewable energy technologies and projects and carbon offsetting projects
- technology commercialisation, joint ventures, intellectual property
- setting up carbon and renewables funds
- participating in national and international emission trading systems
- negotiating carbon trading contracts for CERs, ROCs and voluntary credits (VCUs and VERs)
- the tax treatment of carbon assets and alternative group structure
- 'green buildings' and energy performance certificates
- project insurance, micro-insurance and carbon credit guarantees
- climate change disputes
- regulatory matters
- community based renewable energy opportunities

> *"Steven McNab...has advised on two of the five largest [Clean Development Mechanism] projects under the Kyoto Protocol, the UN agency ICAO on the design of an emissions trading system for aviation [and various] renewable energy projects..."*
> Legal 500

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