Russia’s Strategy on Climate Change Legislation

“How EU climate change legislation will affect the Russian metals industry”

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Abstract

Russia is a party to the 1997 Kyoto Protocol, which calls for a new international agreement to combat climate change. The European Union ("EU") has been pushing hard for such an agreement, which would obviously impact Russia, the third largest greenhouse gas emitter in the world. But the EU is also pursuing unilateral legislative initiatives which would oblige Russia to take action. These include a cap and trade system for GHG emissions; a tax on CO2 emissions and energy content; and the so-called Industrial Emissions Directive. Unless Russia adopts its own climate change legislation, the EU may impose its own rules on Russian imports or stop recognizing Russian emissions allowances. Russia must act quickly to develop legislation that will be seen internationally as equivalent to that of the EU.

1. Introduction

The 2009 session of the Conference of the Parties to the United Nations Framework Convention on Climate Change ("UNFCCC") in Copenhagen did not meet the high expectations of the international community, and of the EU in particular. The Conference underlined the lack of agreement on how best to address climate change and the lack of readiness on the part of most countries to negotiate a new international agreement. However, a new international agreement is needed to fill the gap left by the scheduled expiration of the Kyoto Protocol commitment period. The 1997 Kyoto Protocol committed industrialized countries such as Russia and the EU to reducing greenhouse gas ("GHG") emissions. The emissions reduction commitment period under the Kyoto Protocol will expire on 31 December 2012 and the international community does not seem able to determine what will come next.

One month ahead of the next UNFCCC meeting in Cancun, the EU thus finds itself in a difficult position. Many in the EU now see the Kyoto Protocol, in its current form, as an inadequate and ineffective response to climate change. It seems unenforceable; it has not been universally adopted and recognized; and it does not bind some of the world’s largest GHG emitters such as the United States, China, Brazil and India. Given Kyoto’s
problems, the EU has adopted a much more pragmatic approach to international climate change negotiations and has considerably reduced its expectations. But the EU still wants to be seen as a leader in combating climate change and continues to push for the signature of a new international agreement (section 2). Such an agreement would obviously impact Russia, the third largest GHG emitter in the world.

But there is another objective which conflicts with this effort: that of preserving the competitiveness of EU industry. In its bid to becoming a climate change leader, the EU continues to unilaterally adopt extensive climate change legislation. Since this would impose huge costs on EU companies (section 3), the EU wants to preserve its domestic industry even in the absence of an international agreement. Therefore, the EU is looking at ways to ensure that similar measures are adopted by its trading partners. These unilateral measures would lead to higher costs for the Russian and Central Asian metals industry (section 4).

2. Prospects for international negotiations

As the 2009 UNFCCC meeting demonstrated, there is no international consensus on the best way to address climate change. This suggests that there is little chance of concluding an international agreement on the issue soon – before the expiration of the commitments under the Kyoto Protocol. Since the international community might not be willing to enter into a climate change agreement again without assurances that large emitters such as the United States, China, Brazil and India will join, it is uncertain whether an international agreement will ever be concluded at all.

In light of this, countries have started exploring different options to address climate change. These options fall into three categories.

First, bilateral and multilateral agreements are being pursued by some countries. Under such agreements, countries would undertake to recognize each other’s targets and pledges as equivalent, thereby leveling the operating conditions for companies within their territories with respect to climate change legislation. For example, the EU very recently sought a formal mandate to pursue bilateral talks to link its CO2 emissions trading scheme (see below) to that of Switzerland.

Second, international industrial or sectoral agreements are being considered. These would regulate emission levels in one particular sector or industry. The Organization for Economic Cooperation and Development (“OECD”) has endorsed this approach as a viable alternative to an international agreement. It is particularly relevant in energy-intensive industries traded at a global level, such as iron and aluminum, since their prices are set by the global commodities market and their competitive positions are thus particularly affected by uneven environmental legislation.
Finally, the possibility of imposing national environmental legislation on imports is being explored by several jurisdictions. Even more than the first two alternatives, this approach is primarily designed to preserve the competitiveness of domestic industries and to prevent (domestically established industrial) companies from relocating to jurisdictions with lower environmental standards and thus lower production costs – so called “carbon leakage.”

3. EU Climate Change measures and their cost to EU companies

While pursuing international agreements of various types, the EU is also moving ahead on multiple tracks with an extensive program of climate change legislation. Initiatives include a more stringent cap and trade system for GHG emissions; an energy tax; and the so-called Industrial Emissions Directive (“IED”). These measures will considerably impact EU companies in their ability to compete with entities in Russia and other non-EU countries.

3.1. The EU Emissions Trading System; paying for the right to emit GHG

The EU has already established a cap and trade system for the emissions of its companies. This means that each company is allowed to emit only a certain amount of GHG. If this company wants to emit more than this limit, it must purchase emissions rights or emissions allowances.

In April 2009, the EU revised its Emissions Trading Scheme (“EU ETS”), Council Directive 2009/29/EC, as it will apply as of 1 January 2013. The revised EU ETS brings about a number of significant changes to the system. All will have the effect of increasing costs for EU companies and increasing international focus on climate change legislation.

Reduced cap on emissions rights: The EU has decided to cap the total number of emissions rights. The cap will be set EU-wide, based on the EU's self-imposed legal obligation to cut its GHG-emissions by 20% below 1990 levels by 2020. As the EU announced in late October 2010, the overall cap for EU emissions will be set at 2.039 billion tons, to be divided between 11,000 industrial installations and power plants. This emissions cap will be reduced annually, and is due to be reduced to 21% of the 2005 level of emissions by 2020. The European Commission has also been analyzing the possibility of further reducing EU GHG emissions and of setting a target of 30% below 1990 levels by 2020. If adopted, this would imply steeper emissions reductions and increased prices for emission allowances.

Extension of the ETS to cover new sectors and gases: The new EU ETS covers more industrial sectors, including for example CO2 emissions from the petrochemical, ammonia, aluminum and aviation sectors. In particular, it covers a broad range of
activities related to the production of ferrous and non-ferrous metals. One example is the production of pig iron and steel (primary or secondary fusion), including continuous casting, with a capacity exceeding 2.5 tons per hour. Similarly, the new EU ETS also covers more industrial gases: N2O emissions from the production of nitric, adipic and glycalic acid and perfluorocarbons from the aluminum sector. EU Member States may unilaterally decide to include new gases or new types of activities, subject to approval by the European Commission. Obviously, more EU industrial activity will be affected by climate change legislation due to these extensions.

**Full auctioning of emissions rights:** Previously, emission rights were mostly grandfathered to existing companies. This meant that they did not have to pay for the right to emit. Instead, they were required to (i) surrender a free emission allowance for each ton of carbon that was emitted and (ii) pay for increasing their emissions. Under the revised EU ETS, however, emission rights will be auctioned and companies will have to pay for their right to emit CO2. It has been estimated that in a well-functioning auctioning system, the price of carbon could range between EUR 20 to EUR 40 per ton of CO2 emitted ("ton per CO2"). To compare, for the current ETS, the price for emissions varied between EUR 1 and EUR 30.

While the cost of emissions should therefore increase significantly for EU companies, the effects will vary country by country because emissions auctioning will occur at national level. Companies active in several countries will pay different prices for emissions rights purchased, depending on the total level of emissions allocated and the demand for emissions rights in that particular country.

**Transitional free allocation:** Currently, most EU emissions rights are given away for free. Only 20% of emission rights will be auctioned in 2013. But this figure is due to rise to 70% in 2020 and 100% in 2027. Meanwhile, transitional free allocation will be available to all sectors except the power-generating sector. In order to obtain transitional free emissions rights, however, companies will have to reach a benchmark set for each product and designed to favor the cleanest and most energy efficient techniques. The EU is in the process of developing these product benchmarks, and as such there is often no definite indication of what the precise emissions benchmark will be for a particular industry.

Take basic oxygen furnace steel ("BOF Steel") as an example. Earlier drafts of the EU ETS recommended setting a benchmark level of 1,268 tons CO2 per ton BOF steel. More recent figures indicate the European Commission is currently considering setting the benchmark at 1,328 tons CO2 per ton BOF steel. The EU Steel industry has already

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voiced its concern that even the best performers would not be able to meet this benchmark.

In practice, therefore, only the lowest-emitting 10% of installations in a given sector will get enough free permits to cover all their emissions. All other companies will have to buy at least part of their emissions.

Independent of the cost within specific sectors, industries and companies receiving free emission allowances and not covered by the EU ETS will also be affected by these developments. The EU ETS will increase energy prices for everyone, as power-generating companies will not receive free allowances. This represents an additional indirect cost of production, as energy companies will have no other choice but to pass on these costs to their consumers.

In summary, the revised EU emissions trading system will unilaterally increase production costs for EU companies and the EU will be seeking ways to level the playing field internationally.

3.2. The Energy Taxation Directive or taxes on CO2 emissions and energy content

In addition, EU companies will face a tax on their energy and CO2 consumption. This tax will apply both to companies that are already subject to the EU ETS and to companies that will remain outside it. Indeed, the EU has announced an upcoming revision of the Energy Taxation Directive (“ETD”), Council Directive 2003/96/EC, in order to better reflect the EU’s energy and climate change objectives. The proposed ETD is projected to be published in November 2010.

**Introduction of a minimum carbon tax:** The most important innovation of the new ETD is the introduction of a minimum carbon tax across the EU. The purpose is to set minimum tax rates for energy sources such as petrol, coal, and natural gas when used to produce electricity or as motor and heating fuel. Naturally, EU companies would find themselves at a disadvantage compared to non-EU companies not paying a carbon tax.

**Modification of the tax base rate of the energy tax:** The current regime taxes energy based on the actual quantity of fuel consumed. Under the proposed ETD, however, tax would be determined by (i) the level of CO2 emissions and (ii) the actual energy content. This means that energy sources with high CO2 emissions and low energy content will be heavily taxed. Installations running on coal or oil will therefore be most affected by these changes. Sectors covered by the EU ETS are also subject to the ETD, but are exempted from the CO2-component of the tax.

The European Commission is currently analyzing the optimal tax rate for the CO2 component of the tax. Discussions have fluctuated around a proposed rate of EUR 4 to
EUR 30 per ton CO2. Regardless of the exact rate, the use of CO2 emissions levels to calculate the tax will increase energy costs across the EU.

3.3. The Industrial Emissions Directive – the need to comply with best available technology

A third important legislative development in the EU will hit industrial installations in the EU with increased production and adaptation costs. The EU is set to adopt the so-called Industrial Emissions Directive (“IED”), which consolidates and expands on seven existing directives in the field of industrial emissions. This IED applies stricter limits on air pollution and lays down rules on the prevention and control of pollution resulting from industrial activities. In particular, it sets strict limits on emissions of pollutants such as sulphur dioxide, oxides of nitrogen, and airborne dust.

Extended scope to cover new installations and activities: The IED expands the scope of coverage to include new installations – such as small installations with a rated thermal input of at least 20 MWth – and new activities with an impact on the environment. In the production and processing of metals, the following activities will be covered: metal ore roasting or sintering; the production of pig iron or steel - primary or secondary fusion - including continuous casting with a capacity exceeding 2.5 tons per day; the processing of ferrous metals; the operation of ferrous metals foundries with a production capacity exceeding 20 tons per day; the processing of non-ferrous metals; and the surface treatment of metals or plastic materials using an electrolytic or chemical process where the volume of treatments vats exceeds 30 cubic meters.

Stricter application of Best Available Techniques: Under the IED, industrial installations may only be operated if they have obtained an environmental permit from authorities, which certifies that they apply “best available techniques” (“BATs”). Moreover, the BATs requirement will become stricter, as Member States will no longer be able to depart from these BATs in granting permits unless justified by specific circumstances.

Stricter emission limit values: The IED also addresses the level of emissions for industrial installations. In particular, the new Directive sets lower emission limit values for certain categories of installations, such as large combustion plants, and for certain pollutants. These emission limit values will be set by reference to BATs. Installations will have until 2016 to comply with the stricter limits.

3.4. Estimating the price of the EU’s multiple climate change initiatives

Taken as a whole, these multiple initiatives constitute the EU’s bid to become a climate change leader. The EU process however has often disregarded the enormous costs

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these measures will impose on its own industry and the resulting effect on international competition.

Energy-intensive industries, such as steel, aluminum and non-ferrous metals, are particularly vulnerable to these increased costs. Not only will these industries face the direct costs of their own emissions, they will also have to pay the indirect costs of the emissions of their energy and raw materials suppliers.

For example, based on an estimated price of EUR 30 per ton CO2 under the EU ETS, producers of silicon metal will have to pay, approximately, EUR 120 per ton of product produced to purchase emission rights. Similarly, producers of steel will face additional costs of between 30% and 40% and will have to raise average product prices by at least 6.5% in order to offset these cost increases. As mentioned above, however, these calculations cover only the direct cost resulting from having to buy emission allowances. To this price must be added the indirect costs of increased input such as for instance electricity, iron ore and silicon metal. Reports estimate that emissions rights at EUR 30 per ton CO2 would lead to a 35% increase in electricity price, i.e. an individual value of EUR 62 per MWh instead of EUR 47 per MWh in the absence of emission allowances.

As a result, EU steel producers could lose 8% market share to overseas competitors. Additionally, if the Energy Taxation Directive is adopted, steel producers will also have to pay a tax based on the energy content of the energy source they use in their production process.

Finally, industrial installations will face very high costs from having to adapt industrial installations to BAT. This can be particularly problematic for installations in the non-ferrous and ferrous metals sector, such as steel production. These installations usually plan returns on investment far in the future and operate on a much longer timeframe than the phases of the EU ETS. Moreover, as the product prices of these industries are often set by the global commodities market, it may be difficult for them to pass on the increase in costs to their own consumers. There are obvious implications here for competition in the metals sector between EU and non-EU, especially Russian companies.

3.5. Overlap of the various initiatives

Perhaps surprisingly, the multiple measures that make up the EU’s extensive climate change legislation effort overlap considerably. For example, under the EU ETS, companies can choose whether or not to upgrade their installations to the most

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3 This calculation is based on an average of EUR 4.85 per ton of CO2 per ton of silicon metal.

energy-efficient techniques. If they decline to do so, they need only buy additional emission allowances. However, under the IED, companies are not given this choice; they must simply comply with best available techniques in order to obtain operating permits. While the IED applies only to NOx and SO2 emissions, in practice it would be impossible to adapt an installation to reduce NOx and SO2 emissions without, at the same time, reducing CO2 emissions. Similarly, even though the ETD should not apply to sectors that are covered by the EU ETS, companies that receive free CO2 emissions allowances under the ETS may nevertheless be subject to CO2 taxation (in addition to energy-content taxation) under the ETD.

The overlap will probably result in stricter standards and higher costs, as the most stringent requirements will likely apply in case of duplication or conflict. One wonders whether EU regulators have considered the potential impact of this on EU industry.

4. **EU Climate Change measures and their implications for Russian companies**

As explained above, the EU’s extensive climate change measures will impose huge costs on EU manufacturers. This is turn will affect their competitiveness on the world market, as the EU manufacturers are no longer able to compete with producers from countries with different environmental legislation – like Russia. The EU will therefore have little choice but to react.

4.1. **Why should Russian companies be concerned by climate change initiatives in the EU?**

Russian companies may not feel particularly threatened by climate change itself. Economic studies on the impact of climate change show that Russia (and countries in the former Soviet Union) will not be as affected by the rise in temperatures and other changing climatic conditions as other regions of the world. Indeed, reports show that Russia and CIS countries will suffer the lowest loss of welfare and reduced GDP from adapting to climate change. Russian companies may thus be slow to support climate change measures that will necessarily raise their cost.

However, it has become an absolute necessity for the Russian government to adopt climate change legislation. Russian exports require it. Russia is the third largest GHG emitter in the world, and while the recent Climate Change Doctrine shows a willingness in Russia to address climate change, concrete legislation in the area is still lacking.\(^5\)


Unless the Russian authorities act in this area, the EU may unilaterally impose climate change legislation on Russian imports. This is all the more likely given that the EU’s CO2 intensity of exports stands at 0.47, while Russia’s stands at 3.85.

The question is whether the EU will really penalize Russian exports to support both climate change initiatives and EU competitiveness? Certainly, the EU is committed to both goals; they come together in the EU’s determination to prevent “carbon leakage.” This refers to EU companies reacting to their loss of competitiveness by relocating to countries in which their production costs will not be affected by environmental legislation.

The EU is intent on avoiding carbon leakage for two main reasons. First, carbon leakage would affect the global GDP level of the EU, as well as the number of jobs. Second, if domestic production were to shift to countries where emissions are not regulated, emissions in these countries could grow faster than expected otherwise, leading to an increase in global emissions. This would then mean that EU competitiveness had been affected without concrete climate change results.

Indeed, the EU has already taken up the threat of carbon leakage. The EU is now considering different leverage measures to force its trading partners to adopt climate change legislation similar to its own. Two options are currently being explored: imposing a carbon tax on imports from countries that do not have comparable environmental legislation; and depriving (Russian) projects of EU emissions allowances.

**The threat of a carbon tax on Russian imports:** On this issue, EU industry has already started intensive lobbying. EU companies wish to ensure that imports from countries without climate change legislation should be subject to a compensatory duty. Importantly, a number of EU Member States have also started supporting the idea of a carbon border tax or by including installations from third countries in the EU ETS. Such a compensatory duty would considerably weaken the position of the Russian metals industry. Indeed, Russian companies would face import duties at levels similar to the EU’s industry’s added environmental costs (described above). These duties would be in addition to the costs of having to meet climate change requirements under Russian law and the Kyoto Protocol.

**The threat of depriving Russian projects of emissions allowances:** If Russia did not adopt climate change legislation, Russia may also be vulnerable to leverage on emissions allowances. EU action in this area could deprive Russian companies of significant financial and competitive benefits.

The first area involved would be Joint Implementation Projects (“JI”). The Kyoto Protocol introduced a JI mechanism to enable companies from countries that have committed to
reducing or limiting emissions (in this case EU countries) to undertake emission-reduction projects in transitioning economies such as Russia. EU companies can obtain additional allowance credits in the host country (Russia) which may then be used to meet its emissions target in the EU. Under the JI mechanism, EU companies have an incentive to undertake emission-reduction projects in Russia. Alternatively, some companies may also decide to re-sell these credits under the EU ETS. This therefore represents an important investment and financing opportunity for Russian companies.

Russia is the host state of JI projects, and its legislation determines the conditions and standards for a project to qualify under JI and receive emissions allowances, known here as Emission Reduction Units (“ERUs”) (i.e., individual allowance credits of 1-ton of CO2). If Russia fails to pass climate change legislation, and if the EU decides that Russia’s standards for projects to qualify under JI are too lax, it may refuse to recognize credits obtained in Russia as equivalent allowance. This would severely curtail the participation of EU companies in emissions-reducing projects in Russia and harm Russian industry.

Nor is this risk theoretical. The EU is currently working on introducing qualitative restrictions on similar projects conducted under the Clean Development Mechanism (the equivalent of the JI for less developed countries). There is nothing is to stop the EU from doing the same for JI projects, and this would constitute an important loss of opportunity for Russian companies.

The second area involved would be Russia’s surplus Assigned Amount Units (AAU). The EU is already examining ways to address this issue. Even though Russia is a party to the Kyoto Protocol, it has not committed to reducing its emissions; it has committed only to not raising them above their 1990 level. However, due to the massive deindustrialization that occurred after the fall of communism, emissions never reached the 1990 level. As a result, Russia, Ukraine and other former Soviet countries have huge surpluses of AAUs, which they could sell on the EU ETS market. This would flood the EU carbon market. Emission prices would significantly drop, but companies would have to cut their emissions even more in order to counterbalance this overflow of available emissions units.

One solution to this problem, which the EU has been exploring, is the possibility of canceling all these AAUs upon expiration of the Kyoto Protocol. Another alternative would be to allow these AAUs to be sold, but at significantly discounted prices (80% of their actual value). Either step would represent a lost opportunity for Russian companies to acquire funding.

4.2. What should Russia do to address this threat?
In order to ensure that the EU does not apply a tax on Russian imports to the EU, the Russian Government needs to act. Its strategy should have three parts. First, it should develop climate change legislation that will be seen as equivalent to that of the EU. Second, it needs to develop a strong advocacy strategy in international negotiations, to show that it has already been implementing climate change legislation. Finally, it must convince the EU that Russian climate change legislation is comparable or equivalent to the EU’s, and as such that it would be unjustified to impose a compensatory tax on Russian imports. This comparison could be done at the country level (Russia and the EU), at the sectoral or industry level, or even at the company or product level.

Swift action is needed, however, since Russia’s negotiating position is much stronger now, before the EU actually adopts all of its own planned legislation.