Carbon Matters Summer 2021

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As the UK begins to plan its emergence from the COVID-19 pandemic, businesses are hoping that pent-up demand will provide a stimulus to the re-opening of the economy. However, at least one of the "big ticket" events planned for later this year points to the need to re-open the economy as far as possible on a more sustainable basis.

Following a pre-2021 United Nations Climate Change Conference (known as COP26) meeting in Milan, to be held from 30 September to 2 October, the UK, which is presiding over the COP26 for this year in partnership with Italy, will be holding COP26 at the Scottish Event Campus in Glasgow from 1-12 November.

This will be the largest event ever held in Scotland, and the largest gathering of heads of states and government ever held in the UK. It should therefore provide a significant stimulus to the local economy. It is hoped that it will also advance the UNFCCC agenda.

The UK government, which is heavily committed to the re-opening of the economy in the wake both of the pandemic and Brexit, is also heavily committed to action on climate change. It has appointed a talented team to oversee the COP26 project with a mix of political and business backgrounds. Alok Sharma, the former BEIS secretary, will preside. Nigel Topping, who will be the "High Level Champion" is the former CEO of "We Mean Business," a climate campaign group which seeks to involve influential businesses globally in taking action on climate change. Ann-Marie Trevelyan, the former Secretary of State for International Development and now Minister of State (Minister for Business, Energy and Clean Growth) at BEIS, will be the UK International Champion on Adaptation and Resilience.

Mark Carney, former Governor of the Bank of England, will be the finance advisor to the COP26.

In the build-up to the COP26, and as part of the Budget, the government has announced GBP22 billion funding for a new UK Infrastructure Bank to promote the green economy in areas such as renewable energy, carbon capture and storage, and transportation, offering not only loans, but also advice and support for private sector projects.

The government was keen to make use of the COP26 to secure good relations with the Biden administration given that it had been seen as close to that of the previous US administration and given that President Biden has not been a noted fan of Brexit. Alok Sharma spoke to Secretary John Kerry, appointed as Joe Biden's Special Presidential Envoy for Climate, on the latter's first day in office, and the topic of action on climate change is said to have featured significantly in Boris Johnson's conversation with Joe Biden, one of the first calls taken by the new president from a foreign head of government.

One of Joe Biden's first executive acts on assuming office was to sign a letter initiating the process for the US to re-join the Paris agreement. Since then, Joe Biden has been actively engaged in "rolling-back the roll-backs" of his predecessor, ie using his powers as head of the federal executive to undo some of the relaxations made by Donald Trump of federal controls on business originally prompted by the need for action on climate change. One of the key actions of Joe Biden was stopping the Keystone XL pipeline planned to carry 800,000 barrels of oil a day from Alberta in Canada to the Texan shore of the Gulf of Mexico. Joe Biden has also raised the carbon price used in formulating federal policy initiatives.

It should be borne in mind that state as well as federal regulation is important in the US as regards climate change. Many of the states which are most significant in terms of economic activity have been controlled either by Democrats or by Republicans of a different stamp from Donald Trump. Important measures such as state emissions trading schemes and their combination in the Regional Greenhouse Gas Initiative continued in place during Donald Trump's tenure of the White House. Nevertheless, the beginning of the Biden administration marked a significant change in approach for the US on climate change.

It has also been argued to be a necessary one, given that for all countries the laws of physics and chemistry mean that even rapid changes made now in industrial activity or personal behaviour will not prevent the changes to climate

already in progress. It will take a long time to reverse the effects of past activity, even using existing carbon sinks, which themselves are under threat.

The issue of the time span which will be necessary for change to take effect is illustrated by a slight fly in the ointment on the UK government's spin for COP26.

There has been controversy over a project by West Cumbria Mining to extract metallurgical coal under the sea for use as coking coal from a new colliery to be developed at Woodhouse near Whitehaven that would be used to supply the UK and European steel-making markets.

The project has been approved in principle by Cumbria County Council, and the Ministry of Housing Communities and Local Government has refused, most recently in January, requests to call in the application. It seems that in part the government took that decision because of the positive implications of the project for employment in a depressed area in the Northwest.

On the other hand, the decision was heavily criticised by many Green NGOs on the basis that it would be off-message for the forthcoming COP26. A criticism was put forward by the Committee on Climate Change, not so much on the principle of mining metallurgical coal off the Cumbrian coast now, as on the length of the lifetime for the mine (up to 2049) granted by the draft planning permission. The Committee on Climate Change pointed out that this was far too long, in view of plans to curb the use of coking coal in the steel industry in the UK by 2035.

Coking coal is currently essential for the iron-making part of the steel-making process, and the UK imports extensive quantities of metallurgical coal from the US, Russia and Australia. In consequence it is argued by West Cumbria Mining that their project would avoid much of the carbon emissions involved in the long-distance transportation of coal to steelworks in the UK and the EU.

However, in principle, coking coal could be replaced by lower carbon alternatives. A few weeks ago, Fellows of the Royal Society based in Oxford urged in a letter to the *Times* that the steel industry should adopt a new process recently discovered for disposing of plastic waste. That process would use microwave energy to break down the plastic waste into hydrogen, which could be used to reduce iron ore to iron, and also carbon, which could then be used in the steel-making process.

In principle, that would kill two birds with one stone by reducing carbon emission in the steel industry but also eliminating plastic waste, the impact of which on global bio systems is arguably considerably more pressing an issue than climate change. Climate change, though serious, is necessarily a long-term issue, for reasons including those mentioned above.

However, the new process sounds energy-intensive. It is therefore critical that it is developed not only in such a way as to be practicable on an industrial scale, but one that can also be supplied with economic renewable energy, such as electricity from windfarms. West Cumbria Mining argues that the turbines for these farms will need to be made using steel made with the use of their metallurgical coal. It is in any event clear that considerable time will be required both for the development of practicable technologies and for the necessary investments to be made to install the technology in the UK and EU steel making industries.

Following the criticisms of the Committee on Climate Change, Cumbria County Council has remitted the planning application to its Development Control and Regulation Committee for reconsideration.

The issue of coal mining off West Cumbria makes another point.

Effective action on climate change will depend not simply on what we do ourselves, but also on what others do. As developing countries get richer, their citizens can be expected to set greater store on environmental goals. In the long term there are therefore grounds for optimism. However, in the short term it is crucial that activities such as deforestation do not destroy the carbon sinks we rely on.

The article in this issue of Carbon Matters on the Forest Risk Rules points to steps we can take by preventing the encouragement of deforestation by our own purchasing decisions. However, to prevent land-hungry farmers flocking to the Mato Grosso to cut down the remaining Amazonian rainforest, alternative attractive but sustainable employment will need to be found for them. That will be a longer and much more difficult task than organising a successful COP26.

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The end of the Brexit transition period: New UK ETS and EU ETS obligations

Following the end of the Brexit transition period, the UK has established a new "cap and trade" scheme, the UK Emissions Trading Scheme (ETS), to take the place of the EU ETS.

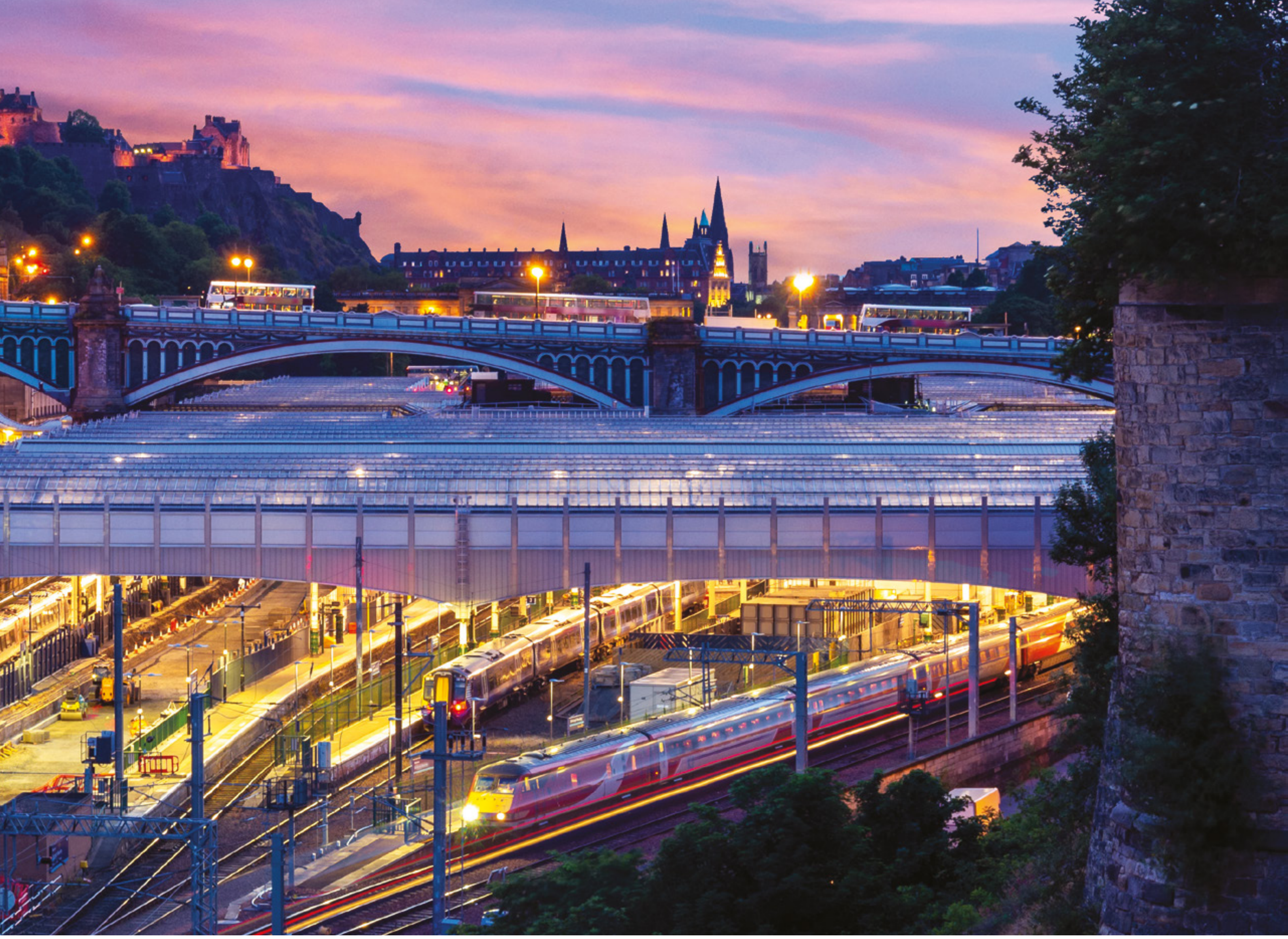
The new scheme was established under the Greenhouse Gas Emissions Trading Scheme Order 2020, and Order in Council made under the Climate Change Act 2008. It will operate under the supervision of the UK government and the three devolved administrations, acting as the UK ETS Authority.

The scheme came into effect on 1 January 2021, the first date of commencement of ten consecutive scheme years. It is initially a stand alone scheme, but the UK government intends to link it to other schemes internationally, as and when that can be agreed.

Like the EU ETS, the scheme applies to specified energy intensive industries, the power generation sector, and other large combustion installations (other than those for hazardous and municipal waste incineration). It also has some application to the aviation sector.

As regards aviation, its scope will include UK domestic flights, flights between the UK and Gibraltar, and flights departing the UK to all EEA destinations, regardless of the nationality of the operator company.

From an administrative and regulatory point of view, the UK ETS is essentially a continuation in mirror form of the EU ETS, so its workings will be very familiar to affected operators. However, the target for carbon reduction is more ambitious, the initial cap being set at 5% lower than the UK's share under Phase 4 of the EU ETS, in line with the UK's commitments to achieve net zero by 2050.



Following amendments made to the 2020 order, the legislation provides for a separate registry for the UK ETS and for the free allocation of allowances to certain qualifying operators. For this purpose, existing EU legislation, the Free Allocation Regulation and the Activity Changes Level Regulation have been adapted for use under the UK ETS.

Operators who are existing operators under the EU ETS received the main parts of their UK ETS permits towards the end of 2020 under the automated ETSWAP system, so permits would be in place at the beginning of the first scheme year. The different national regulators will be attaching the methodology plan to relevant permits and also making amendments relating to Free Allocation of allowances in early 2021. Existing operators will also be contacted by the Registry Administrator regarding the establishment of the operator holding accounts necessary to acquire and surrender allowances in line with their obligations. However, they will need to complete the process of establishing these accounts and the government has warned that this process can take a number of months.

The UK ETS Authority and the national regulators plan to issue guidance on how operators should comply with the scheme in the early part of this year.

UK operators are still required to comply with their obligations under the EU ETS for the 2020 scheme year, notwithstanding Brexit. Verified emissions reports for 2020 must be submitted by 31 March 2021 and allowances for the 2020 emissions but surrendered by 30 April 2021. UK regulators have continuing powers to enforce these obligations and UK enforcement of obligations is a requirement under the Withdrawal Agreement. To comply with their obligations, operators will retain access to their accounts up to 30 April 2021, but access may not be possible after that date.

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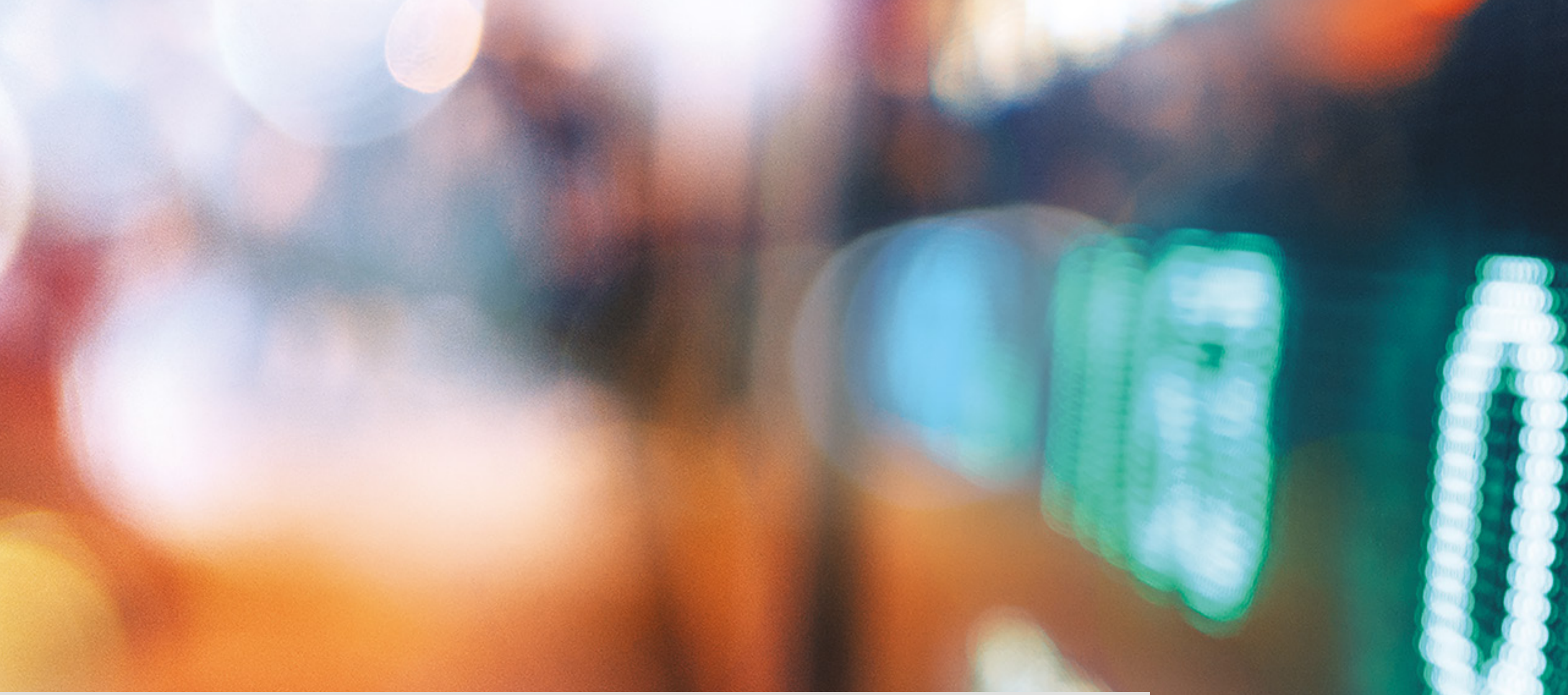


Climate Change Agreement scheme extended until 2025

Following a recent consultation, the Department for Business, Energy and Industrial Strategy (BEIS) has confirmed that it intends to extend the voluntary Climate Change Agreement (CCA) scheme until 2025.

The scheme, which is estimated to prevent 700,000 tonnes of CO2 from being emitted each year, will also, according to BEIS, save participant companies up to GBP300 million per year.

CCAs set targets for reducing businesses' energy use in return for a discount on the climate change levy applied to energy bills. According to BEIS, since 2013 the CCA regime is estimated to have helped companies reduce energy use by up to 2.3 terawatt hours a year – enough energy to power 140,000 homes.

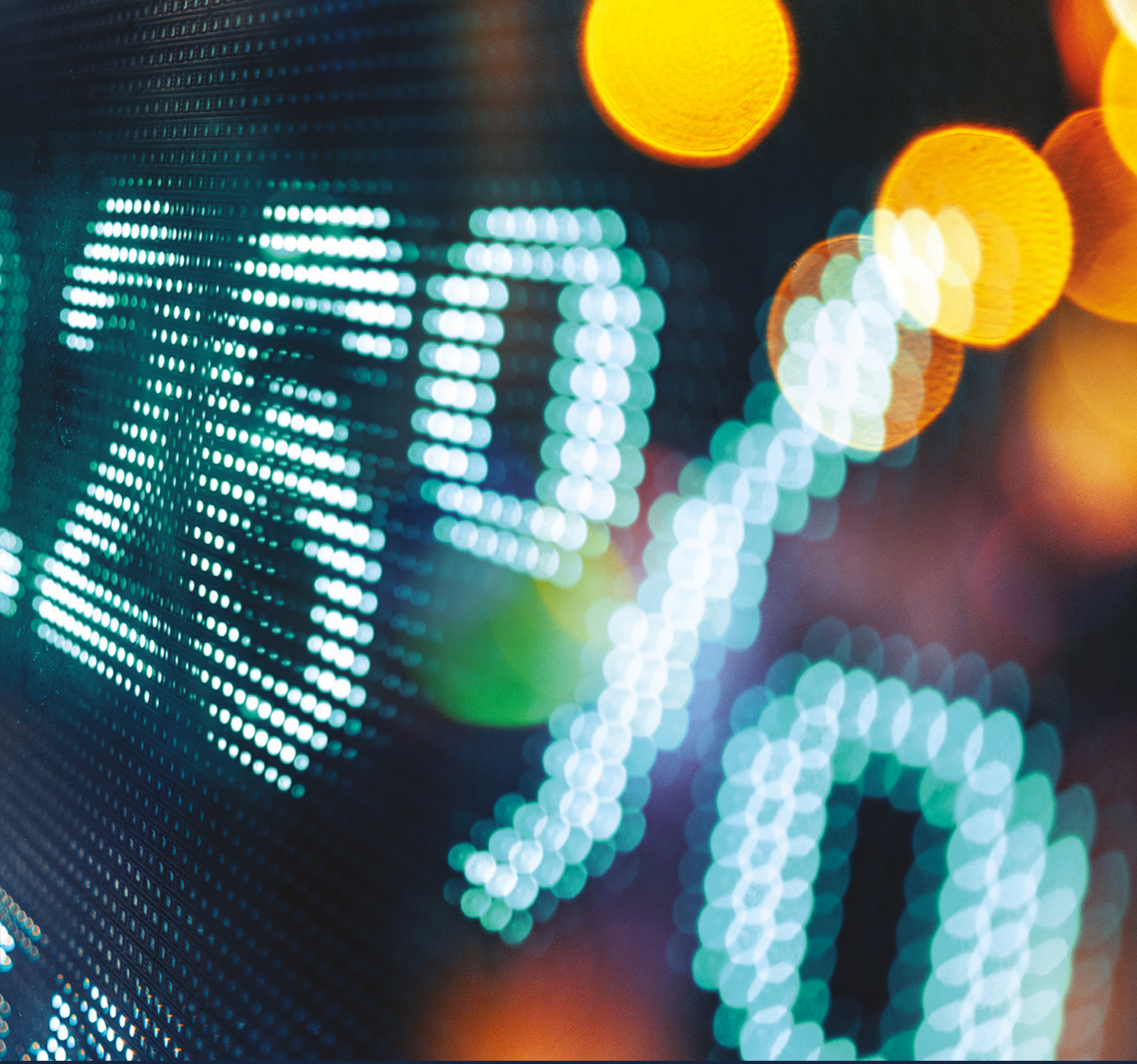
The extension will allow new targets to be implemented from January 2021 and for the scheme to extend to March 2025.

The responses to the consultation are understood to have demonstrated strong support for the continuation of the scheme and industry figures have welcomed the fact that new businesses will also be allowed to apply to join as of January 2021 – an initial September deadline for applications for new entrants has also been extended to 30 November.

There will also be changes to both the baseline period for emissions cuts and the "buyout price." Currently, the baseline period is set at 2008, which is generally considered outdated and will therefore be updated to 2018. The "buyout price," the amount that organisations must pay for every ton of CO2 they fail to cut from that pledged under the scheme, is set to increase from GBP14 to GBP18.

An evaluation of the scheme was published at the same time as the announcement and identified that:

- The scheme has been popular with the industry, with between 80-100% of businesses participating in the most eligible sectors and the main motivation for joining being energy cost reductions (particularly the climate change levy discount).



- 92% of participants reported that they were likely to continue in the scheme and participate in a future scheme, if there is one. It was seen by participants and sector associations as one of the few policies providing a positive incentive for energy efficiency.
- Slightly more than half of target units achieved their targets with no use of buy out or surplus and the average level of underperformance was low.
- A complex set of factors affected the degree of CCA influence on specific firms, with less influence on firms that were either very large/energy intensive or very small/non-energy intensive. The research suggested that the CCA tended to have more influence on: firms that had not previously taken a systematic approach to energy efficiency; those that faced challenging targets; those that had a culture of complying with targets; those that had strong board level engagement with energy; those with keen energy managers; and those that ring fenced CCL savings to fund energy measures.

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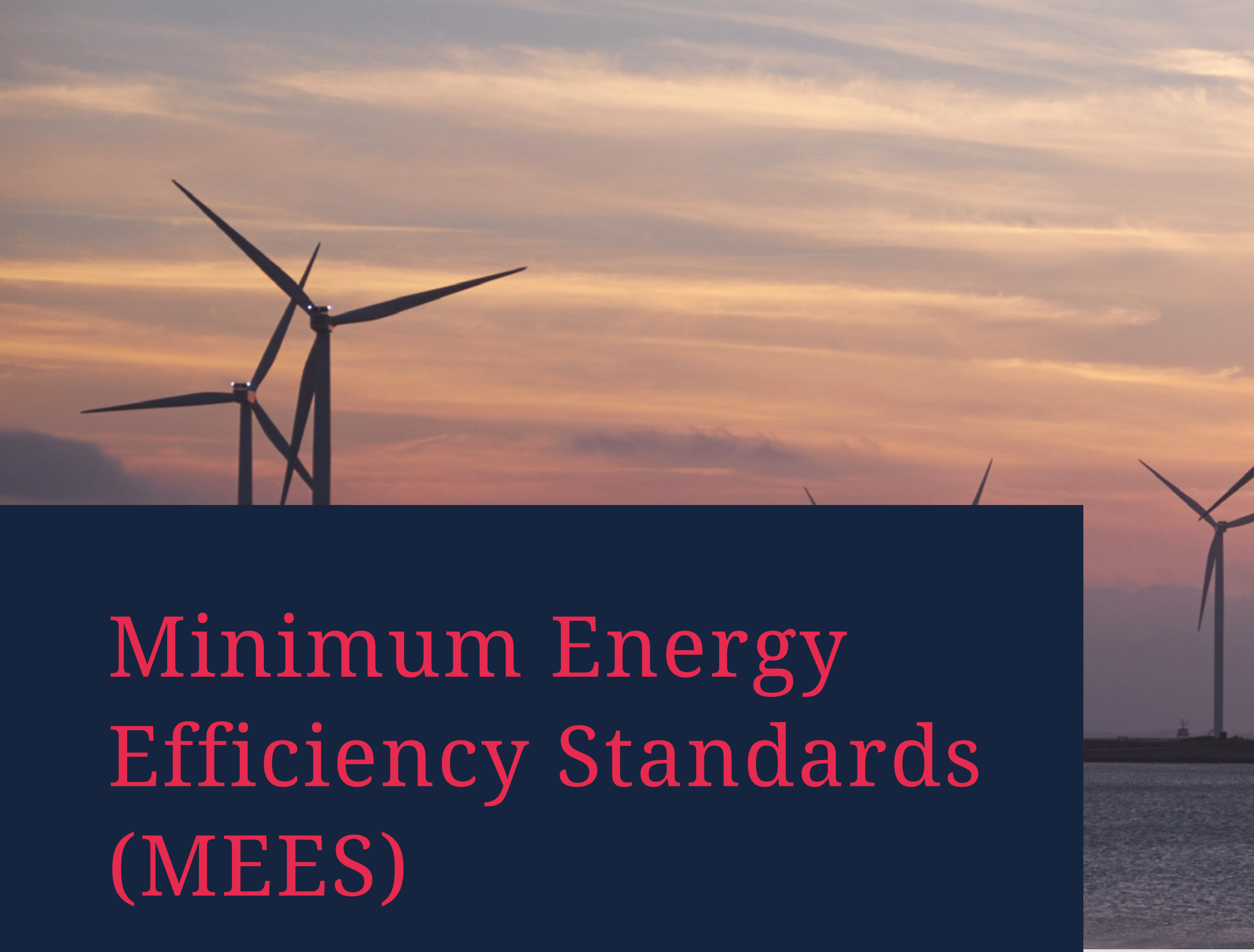


Minimum Energy Efficiency Standards (MEES)

The MEES were introduced by the Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015 (MEES Regulations).

The MEES Regulations rate properties as "sub standard" if they have an F or G rating.

Since 1 April 2018, landlords of both domestic and non domestic private rented property have been unable to grant or renew leases if the building does not have a valid EPC with a minimum rating of E.

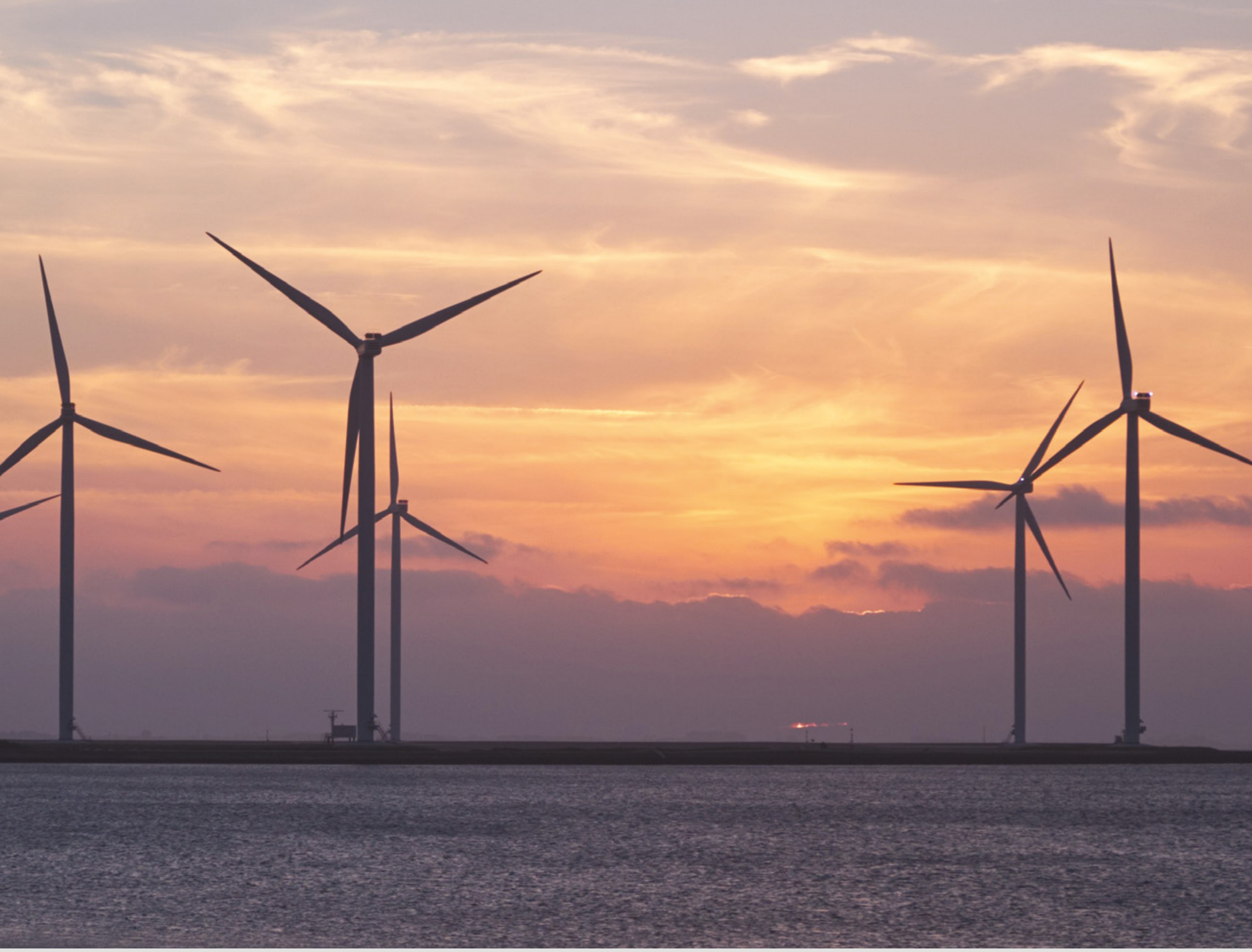
On 1 April 2020 this position changed. While landlords of non domestic properties have until 1 April 2023 to bring their EPC ratings up to an E rating where there has been no change in tenancy arrangements, landlords of domestic private rented properties are prohibited from continuing to let sub standard property.

If the landlord's property is let on an assured tenancy, a regulated tenancy or a domestic agricultural tenancy and it is legally required to have an EPC (if it has been marketed for sale or let, or modified, in the past ten years) and it has a rating of F or G, the landlord must take appropriate steps to comply unless there is one of the seven valid exemptions in place. Where an exemption applies, it must be registered by the landlord (or agent for the landlord) before it can be relied upon.

A landlord will not be required to spend more than GBP3,500 (including VAT) on energy efficiency improvements. If the landlord cannot improve the property to an E rating for GBP3,500 or less, then they should make all improvements that can be made up to that amount then register an "all improvements made" exemption.

There are three ways to fund the improvements:

- Third-party funding, eg Energy Company Obligation: Help to Heat, Renewable Heat Incentive, Green Deal finance. Note, if this is secured, the cost cap does not apply and the landlord should make use of all the funding secured to get the property to band E or, if possible, higher.



- Combination of third-party funding and self funding. If the landlord secures some third-party funding but it is less than GBP3,500 and not enough to improve the property to EPC E then it will be down to the landlord to top up by self funding the shortfall. Any energy efficiency investment made to the property since 1 October 2017 can be counted within the cost cap and if the property can be improved to an E by spending less than GBP3,500, a landlord will have met the obligation.
- Self funding: If a landlord is unable to secure any funding, to be able to continue to rent out the property, self funding will be necessary up to the sum of GBP3,500 to make the improvements.

The EPC report will include a list of recommendations detailing measures to improve the energy efficiency of the property.

If a property fails to meet the minimum rating and a valid exemption is not registered, the Local Authority may take enforcement action. Such enforcement action may include imposing fines of up to GBP4,000 where the property has been let out to tenants in breach of the MEES regulations for a period of three months or more and the landlord will be unable to serve a Section 21 notice seeking possession. This could cause significant problems for the landlord in obtaining vacant possession of their property.

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Forest Risk Rules

In August 2020, the UK government announced an initiative aimed at preventing UK companies from encouraging in their purchasing decisions unlawful deforestation abroad, which is threatening biodiversity and hampering global efforts to combat climate change.

Clause 107 of, and Schedule 16 to, the Environment Bill currently before Parliament will make provision for the making of secondary legislation enforcing "Forest Risk Rules."

Those Rules will prohibit companies established in and operating in the UK from using in their supply chains "risk commodities" and materials derived from them. Such companies will also be required to establish and implement a due diligence system to identify, assess and mitigate the risks of illegal deforestation and failures to comply with local laws in their supply chains. A due diligence report will have to be submitted to the enforcing authority, and will also have to be made public.

Current indications are that the list of "risk commodities" will initially include, beef, cocoa, leather, palm oil, rubber and soya. These are the prime commodities whose production is currently considered to be driving deforestation, particularly in those tropical and sub-tropical regions that are of key importance for global bio-diversity. Derived materials are likely to include alcohol from palm oil, dairy products from soya, and flavourings from cocoa.

Compliance with the Rules will mainly be enforced by civil sanctions, with the option of criminal prosecution being available where it is considered that those sanctions would not provide a sufficient disincentive against non-compliance. It is envisaged that a defence would be provided to show that "all reasonable steps" had been taken to avoid non-compliance. However, case law on the application of similar defences in other statutes suggests that such a defence is only likely to succeed in quite exceptional circumstances. That is because in interpreting such a defence the courts would be likely to place the emphasis on the word "all" and not on the word "reasonable."

It will also be noted that the scope of the risks to be addressed is quite narrow, focussing on what would be unlawful under local laws. Relevant categories of laws will be specified in the secondary legislation, but it is understood that they will relate to land ownership and use. There has been some criticism of this proposal from NGOs, on the basis that broader human rights and environmental considerations should also be addressed. As far as human rights are concerned, the point is made that the UK is committed internationally to upholding human rights standards. That comment is correct, but the UK's obligation only extends as regards the UK itself, and to territories and activities under the control of the government. It is not committed to policing the upholding of those rights in other countries, although it may – and indeed does – make representations to other governments on such issues if this is considered appropriate. The UK government is also constrained by international law as to the extent to which it can interfere in the internal affairs of other countries. That point applies with even greater force to companies that do not have international standing, and may not themselves even be operating in those jurisdictions. As a practical matter, it should also be borne in mind that most of the countries where there is a deforestation risk do in fact have laws restricting it: it is usually only the enforcement of those laws which is deficient.

The passage of the Environment Bill through Parliament has been delayed due to more urgent priorities, and it is not now thought likely that Royal Assent will be given before the autumn. However, work is proceeding on the draft Rules, and there will be a public consultation on them in March/April with a view to them being brought into force in October or November of this year. That will provide affected businesses and other stakeholders an opportunity to make representations on the detail of the Rules.

Following this, establishing mechanisms for compliance is likely to be a fairly urgent priority for affected businesses to avoid significant penalties and reputational risk.

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