



**Post-Copenhagen:
four unavoidable truths**



The outcome of the recent United Nations Climate Change Conference in Copenhagen has been regarded by many as a huge disappointment. In terms of achieving a binding and unambiguous global solution, Copenhagen seems to have been something of a missed opportunity. However, this should not overshadow the fact that industry all over the world is going to have to brace itself against a storm of regional and sectoral regulatory activity directed at combating climate change. This review explores what precisely is looming on the horizon.

Notwithstanding the disappointing outcome of the recent United Nations Climate Change Conference in Copenhagen, industry can expect to contend with:

- 1 governments putting an ever higher price on carbon through the use of regulated markets;
- 2 institutional investors continuing to force disclosure of climate risks by various means;
- 3 movement towards voluntary and mandatory product labelling schemes; and
- 4 energy and climate change policy intruding further into the built environment.

Introduction

There is still a great deal to be resolved following the negotiations in Copenhagen, where talks concluded without establishing a new deadline for a legally binding treaty to succeed the Kyoto Protocol. Although it became apparent even in the days running up to the negotiations that a final international legal agreement was unlikely, most will be left disappointed with the vague and non-binding Copenhagen Accord eventually brokered at the last minute. The Accord recognises that global temperature increases should be limited to two degrees Celsius, but does not provide a roadmap to achieve that goal.

That said, a number of important themes came into focus in Copenhagen. Above all else, the negotiations have shown how the issue of climate change has come to the fore in international relations. The question of how to decrease greenhouse gas emissions (as well as the accompanying debates on how best to mitigate the effects of climate change) is now firmly rooted on the agendas of developed and developing countries alike. Climate change as a hot topic is set to stay with us and will continue to dominate the international agenda.

Although the negotiations and resulting draft text have done little to spell out a plan for international burden sharing or identify emissions-reduction mechanisms, the recognition of a maximum two degrees warming target is significant: the scientific consensus, which most governments accept, is that emissions would need to be reduced to roughly half their 1990 levels in 2050 for the world to reach this goal. Taking into account the fact that developing countries will be growing over the coming decades, this means that rich countries will need to slash emissions by about 80 per cent over the next 40 years.

Most of the rich world has already made significant domestic political commitments to cutting greenhouse gases. Even without a stringent successor treaty to the Kyoto Protocol, the response to climate change will be global and multifarious. If the UN process does not result in an outcome that is satisfactory to the major players (the EU as a bloc originally insisted on going down the Kyoto path), then regimes based on regions, sectors or common interests may well develop and fill the gap.

Although Copenhagen itself may have been a missed opportunity, therefore, a continued storm of regulatory activity is still on the horizon. Furthermore, wheels were set in motion to extend existing initiatives as well as introduce new measures long before Copenhagen was even on the agenda. To achieve the sort of reductions outlined above, governments will continue to be compelled to force a change in the very framework of production in which businesses operate. This has the potential fundamentally to impact the way companies are run forever. Green credentials of individual businesses will be brought more sharply into focus than ever before and will act as an important basis for consumer and investor choices.

Carbon markets

Copenhagen has not provided the carbon markets with the regulatory certainty that investors were hoping for: when trading opened on the Monday following the conference, the price for EU allowances fell considerably. However, the substantial recovery of the allowance price over the following days and weeks highlights an even more important fact: that the carbon markets stand on several regulatory pillars and do not simply collapse in the face of uncertainty regarding the UN framework.

Putting a price on carbon through the use of regulated markets will continue to play a crucial role in the international response to climate change. The EU is committed to continuing with its flagship cap-and-trade emissions trading scheme (ETS), which will increasingly exert pressure on those companies falling under its scope. The number of allowances that can be allocated to sectors deemed insufficiently energy intensive and trade-exposed to induce 'carbon leakage' (of carbon-intensive industry to unregulated jurisdictions) is also going to be steadily reduced, with a view to having no free allocations by 2027. In any event, there is already a trend among member states towards increased auctioning of allowances, rather than issuing them free of charge.

Australia, Canada, Japan and New Zealand are all developing their own domestic cap-and-trade schemes and a bill that would introduce one in the US is controversial, but still expected by many to be passed into law at some point during 2010. In the run-up to Copenhagen and during negotiations, India and China both offered carbon-intensity targets, which may incorporate flexible trading elements.

Some governments are also employing a carbon tax on fuels to increase the price of carbon-intensive goods relative to the products of more carbon-efficient production processes. Norway, Sweden and Ireland are among those that have already implemented such a tax. France, too, is introducing a carbon tax this year, despite industry protests about competitive disadvantage and a court ruling forcing it to increase its scope.

The price of carbon as an input will clearly have a direct effect on the cost of doing business. How disruptive this is depends on the reliance governments place on market-based regulatory mechanisms to induce the revolution that will be required to achieve a low carbon economy. If European governments intend to live up to the intentions they proclaimed in Copenhagen and domestically, it is likely that they will introduce a high, long-term carbon price (see our piece on *Getting the carbon price right* on www.freshfields.com). This will of course not be without controversy. In the absence of integrated, worldwide carbon markets, a higher carbon price will place European industry at an even greater competitive disadvantage relative to global competitors operating outside any equivalent scheme. Amid inevitable accusations of the EU ETS being an 'island solution', effective regulatory support will be essential to help redress the imbalance.



Disclosure to shareholders and other voluntary disclosure schemes

As carbon regulation gains significance and an increased carbon price looms on the horizon, investors are paying ever more attention to the risks associated with corporate exposure to expected regulatory activism in this area.

Influential institutional investors are trying to force disclosure of climate risks by various means. For example, the Carbon Disclosure Project, an organisation for institutional investors with \$55 trillion-worth of assets under management, asked the 2,400 largest companies to disclose their climate risks and published the answers.

In the US, in November 2009, another group of institutional investors renewed a petition to the Securities and Exchange Commission (SEC) to require public companies in the US to disclose more about their financial exposure to global warming and their greenhouse gas emissions policies. In response, the SEC is considering whether to issue interpretative guidance on the meaning of 'material risks' in companies' annual filings. In addition, the US Environmental Protection Agency (EPA) has now finalised a mandatory greenhouse gas reporting rule that, starting in 2010, will require large stationary sources of greenhouse gases to report their total emissions to the EPA annually.



In the UK, the Climate Change Act requires the government to introduce regulations requiring the mandatory reporting of greenhouse gas emissions information by April 2012 or to lay a report before parliament explaining why this has not happened.

There are at present no mandatory EU regulations requiring the disclosure of climate risks. That said, the due diligence undertaken by investors in transactions involving the acquisition or sale of businesses already incorporates many of the questions that investors are becoming interested in asking. Increasingly, it is not only the traditional 'dirty' industries that need to be concerned about how carbon regulation can affect their significant regulatory obligations and the bottom line. Although some businesses have not yet fully woken up to the fact that they, too, are now in the purview of the carbon regulators, investors tend to be more aware of the scope and import of current developments.

Product regulation and labelling

Consumer products will also continue to be subject to increasing scrutiny and regulation in the name of climate protection. This has a double function: on the one hand, it is basic 'command and control' regulation at work; on the other hand, it is supposed to give a climate-aware body of consumers the ability to make informed consumption choices. A sign of Europe's intent in this regard may be seen with the recent recasting of the Ecodesign Directive – the framework directive that defines the principles, conditions and criteria for setting environmental requirements for energy-using or related appliances. The most recent list of product groups considered to be in priority need of specific measures contains products as diverse as food-preparation equipment, electric and fossil-fuelled heating equipment and air-conditioning and ventilation systems. This is in addition to the two-dozen products that have already had implementing measures imposed on them.

Consumer-orientated product labelling schemes such as Project Carbon Footprint in Germany add impetus to a culture of carbon disclosure. In the UK, the Carbon Trust has been instrumental in devising and operating the Carbon Trust Label scheme (adopted by high-profile retailers), as well as developing the PAS 2050 standard as a means of establishing a unique standard for the consistent assessment of greenhouse gas emissions embodied in goods and services. The Carbon Trust Standard is an example of a voluntary standard that has been incorporated into mandatory regulation: in the context of the UK's Carbon Reduction Commitment (see below), a business may receive substantial benefits from Carbon Trust certification, provided that it has the paper trail to substantiate its green claim.

The lesson for regulated industries is that today's voluntary initiative can become tomorrow's mandatory standard, as regulators cast around for tried and tested ideas. With the ubiquity of green claims comes closer regulatory scrutiny and increasing regulatory definition of terms such as 'climate friendly' and 'carbon neutral'. What a few years ago might have been an advertising ploy, like any other 'soft' benefit, will need to be scientifically substantiated in a manner increasingly resembling the stringent regulatory requirements of health claims in the pharmaceutical industry.

Energy efficiency regulation in the built environment

A very large proportion of EU greenhouse gas emissions (upwards of 40 per cent) comes from the built environment. To address this, the German government, for example, is increasingly resorting to mandatory measures such as the Energy and Climate Programme it adopted in Meseberg in August 2007. In particular, it has increased obligations to retrofit and upgrade existing buildings. A government proposal to give tenants a legal right to rent reduction if the landlord has failed to meet energy efficiency standards could have far-reaching implications.

In respect of the energy efficiency of activities within buildings (as opposed to the buildings themselves), intrusive, ongoing regulation of energy consumption is a popular alternative to forcing companies' attention through a high carbon price. For example, the

UK's forthcoming Carbon Reduction Commitment Energy Efficiency Scheme is a new compulsory domestic scheme for large non-energy-intensive businesses. It will force the measuring and monitoring of emissions in sectors that have not traditionally paid much attention to energy management.

Given that the built environment and non-energy-intensive activities going on within it present the greatest potential for efficiency gains and energy savings, this is a key area for future energy and climate change policy. One way or another, both existing and future 'management regulation' is likely to touch all companies with substantial physical assets, including service businesses.

Conclusion

For those immersed in the EU and international climate change debate, it has been clear for years that the scientific consensus on climate change necessitates a regulatory paradigm shift, designed to spark a change akin in magnitude to a third industrial revolution.

The UN-sponsored conference at Copenhagen in December has failed to deliver on much that participants hoped for and, as a result, has delivered something of a blow to industries that have already begun strategically to capitalise on low-carbon solutions. But this does not mean that industries that are not adapting to the changing regulatory landscape can bury their heads in the sand – one thing demonstrated by the global reaction to the outcomes of Copenhagen is that climate change is a real concern around the world, occupying heads of state and rallying developed world governments to commit billions during hard economic times. Moreover, much of the regulatory action planned at EU and national levels is independent of progress at the UN. Although the EU pledged to do more if other countries followed suit, a political decision has long been taken to de-carbonise the European economy.

So what next? Talks with an aim of achieving a legally binding agreement will resume in Mexico City in late 2010. Before that, several key building blocks will have to be supplied: rich countries are to submit their emissions reduction targets by the end of January. How the US will deal with this if it has not yet passed domestic climate change legislation at this point is unclear, but much will continue to depend on the eventual outcome of a tense domestic debate. Indeed, the passing of any US domestic legislation will do more than anything else to revive the Copenhagen agenda and renew interest in a global solution.

If other countries do not introduce equivalent measures, the possibility of introducing border tariffs to prevent carbon leakage will no doubt again come to the fore: no country can afford unilaterally to put too onerous a burden on its industry and expect it to weather international competition. The concept has been explored in the EU and is popular in the US. The EU's qualms about introducing barriers to trade may well diminish if the US goes ahead with a measure of this kind, but China has already made it clear that it would regard such a move as the beginning of a serious trade war.

For business, whether it is likely to profit from carbon regulation or be burdened by it, early anticipation of the issues emerging from the ongoing national and international debates will be crucial to maintaining competitiveness and keeping ahead of the game.



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