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The potential impact of Brexit on the EU ETS and future UK climate policy

The outcome of the Brexit referendum will have no immediate impact on UK compliance entities or non-compliance entities that are active in the EU ETS. Even once the notice to withdraw from the EU is delivered by the UK to the EU, a negotiation process will follow, dealing with the terms of the UK's exit along with negotiations for the future of the UK's relationship with the EU.

Although there is a timeframe under Article 50 of The Treaty on European Union limiting the window for negotiations to two years, this window can be extended with the agreement of the EU Council of Ministers. Given the complexity of the above-mentioned negotiations, this timeframe may very well need to be extended.

Once agreed and implemented, the exit may happen at a point that is midway through a phase of the EU ETS. This could make the transition more challenging. With respect to its role as a signatory to the Paris Agreement, the UK may need to submit its own NDC as, at the time the country obligations kick in in 2021, it may not be part of the EU.

In the longer term, it is also possible to anticipate an indirect impact on EU ETS environmental policy going forward, triggered by the UK no longer being a leading advocate on the subject within the EU.

Introduction Through a referendum held on the 23 June 2016, the United Kingdom has voted to bring an end to its membership of the European Union. The process that follows will involve a notice of intention to withdraw (**Article 50 Notice**) being delivered by the Government of the UK under Article 50 of the Treaty on European Union (**TEU**) to the European Council. That notice will start the process for negotiating and concluding an agreement with the EU, setting out the arrangements for the UK's withdrawal¹. It is not clear when the UK Government will serve the Article 50 Notice but it is unlikely to be until a new Prime Minister is appointed following the current Prime Minister's decision to resign. Of course, even when the Article 50 Notice is served, there is no immediate legal effect on the current laws, or current rights or obligations

of UK citizens or businesses, that arise from the UK's membership of the EU even ignoring the further permutations that the prospect of snap general elections and/or further referenda may produce.

There is no precedent for the exercise of the right of withdrawal provided for by Article 50 of the TEU². As such, over the course of the next few weeks and months both the UK and the EU will be establishing and determining how an Article 50 withdrawal works, in practice, for the very first time. It is worth noting that EU laws, once transposed into the laws of the UK are, for all intent and purpose, UK laws and a withdrawal will not affect the application of those laws³.

If an agreement on withdrawal is reached, the current EU laws in the UK (that are not already the laws of the UK⁴) will expire from the date of entry into the withdrawal agreement. If an agreement is not reached, then the current EU laws in the UK (that are not already the laws of the UK) expire two years after the date of the Article 50 Notice. As such, the deadline for reaching any agreement will be two years from the date of the Article 50 Notice. Of course, with unanimous support of the members of the European Council, an extension of this period may be agreed with the UK.

The UK's legislative history, including that in relation to its energy and climate change policy, has been intertwined with that of the EU for the past 44 years. As highlighted by a recent House of Commons Environmental Audit Committee report⁵, "A large proportion of UK environmental policy is shaped at EU level". It is no small feat to work out precisely how that can be unravelled through the negotiations anticipated over the next two years. The same report notes that the Government does not have contingency plans for what would happen to environmental regulations if the UK were to leave the EU. Many commentators suggest that the withdrawal negotiations may be a long drawn-out process requiring the European Council to extend the two-year period. It is likely that the negotiation of the UK's withdrawal from the EU will occur in parallel with the negotiations on the future relations between the UK and the EU. In order to ensure as smooth a transition as possible, it is likely that the two sets of negotiations will be closely coordinated.

The purpose of this client paper is to consider some of the possible impacts of the referendum outcome on the EU Emission Trading Scheme (**EU ETS**) and on the UK's own climate change policy.

The exit date The UK used to have its own emissions trading scheme (**UK ETS**), which was phased out with the introduction of the EU ETS⁶. One option for the UK, after an exit from the EU, is to re-establish its own UK ETS and pursue a path of linking it with the EU ETS. The foundations for doing this exist pursuant to the UK's own Climate Change Act 2008, which requires the Government to set a series of carbon budgets to enable at least an 80 per cent reduction of greenhouse gases by 2050 as compared to 1990 levels.

The EU ETS is currently in the middle of its third phase, which expires on 31 December 2020. 1 January 2021 is, therefore, a natural break point in terms of the nature of any changes to the UK's involvement in the EU ETS.

This date also coincides with the end of the second commitment period under the Kyoto Protocol and the targeted start date for obligations under the Paris Agreement⁷.

Given the mountain of other issues the UK Government will have to negotiate with the EU, there can be no confidence that this convenient timing will be achieved. As such, it is possible to contemplate at least two other scenarios: one where the UK is not part of the EU ETS prior to the end of phase 3, and another where it is part of the EU ETS even after the start of phase 4. However, any mid-phase change will be chaotic and difficult to manage. After all, the UK's 780 installations accounted for 10.5 per cent of the EU ETS's total verified emissions (1.6 billion tonnes) in 2015.

There will be a number of implications of a mid-phase change, including in terms of the:

- i. Ability to effectively manage compliance deadlines for UK compliance entities within the EU ETS
- ii. Certainty of the quantities for allocation of allowances
- iii. Carrying out of UK EU allowance (**EUA**) auctions and the effect on the number of UK EUAs that were due to revert back into the system at the end of Backloading⁸ (except for the impact of the Market Stability Reserve (**MSR**)⁹)
- iv. January 2019 implementation date of the MSR¹⁰ and its impact on the level of EUAs in the system
- v. Risk management strategies that a UK compliance entity deploys with regards to banking EUAs into the next EU ETS phase
- vi. UK's position in using the Union Registry (in contrast to using its own Kyoto registry¹¹)

This is not an exhaustive list and many other issues are likely to also arise. For example, any changes introduced to the EU ETS to address the outcome of the ICAO¹² assembly vote in September in relation to the introduction of a global market-based mechanism for international aviation and the impact that will have on the hundreds of aircraft operators regulated by the UK. Similarly, how will the UK contributions and obligations under the 2009 Effort Sharing Decision¹³ for emissions from sectors not included in the EU ETS (e.g., transport (although excluding aviation and international maritime shipping), buildings, agriculture and waste) be addressed? Presently, the UK, along with other Member States, has an annual emissions allocation for the years 2013 to 2020¹⁴ under the 2009 Effort Sharing Decision.

The above situations are also applicable with a 31 December 2020 exit. However, the difficulty in recalibrating EU allocation and auction volumes to adjust for the UK's share in the EU ETS, in terms of the number of UK EUAs, its greenhouse gas emissions as well as its obligations/contributions under the effort sharing arrangements with other EU Member States, would have been

easier because much of the EU ETS calculations are based on numbers set or reset at the start of each of its phases.

The UK relationship to the EU ETS after the exit date The determination of what will happen in each of these situations is likely to be further influenced by the nature of the UK's participation in the EU ETS after the exit date. This will be resolved by the negotiations on the future relationship between the UK and EU and not by the withdrawal negotiations. Although it is entirely possible that the UK may not seek in any way to maintain a link to the EU ETS, given its long-standing support for the EU ETS, some form of future linkage seems more likely at the present time.

Of course, within the ways in which the UK may join the EU ETS, there are many different scenarios, including but not limited to those commonly described as the 'Norway Model', the 'Swiss Model' and the 'FTA Model'.

In brief:

- The Norway Model assumes the UK would join the European Economic Area (EEA) and the European Free Trade Association (EFTA), thereby giving it access to the single market and subjecting it to EU standards and regulations without much ability to influence them. Under this situation, the UK would participate in the EU ETS in the way Norway, Iceland and Liechtenstein currently do¹⁵. Incidentally, in the case of Norway, it had its own emissions trading scheme at the time the EEA agreement was amended to incorporate the EU ETS. Therefore, this required the negotiation of a bilateral link between Norway and the EU ETS to address the overlap of its scheme from phase 1 to phase 2 of the EU ETS. However, neither Liechtenstein nor Iceland had their own scheme at that time. As such, the UK could, by becoming an EEA and EFTA member, participate in the EU ETS with the least amount of disruption provided that the timing of its exit from the EU, its membership of the EEA and EFTA and the establishment of its relationship with the EU after its exit as a Member, were all to coincide.
- The Swiss Model assumes that the UK would join the EFTA and negotiate bilateral agreements governing UK access on a sector-by-sector basis. The UK could agree to negotiate a bilateral agreement linking the UK ETS to the EU ETS, in the same manner that the Swiss have agreed to link their emissions trading scheme to the EU ETS. However, because of the delay in Swiss ratification of the linkage agreement (and the lack of public information regarding the terms of the linking), it is unclear whether the Swiss would use the Union Registry after its linkage.
- The FTA Model assumes the UK would sign a free trade agreement with the EU which would include in its terms arrangements concerning the EU ETS.

In all but the Norwegian Model, it is likely that the UK would need to first establish its own UK ETS, which could be very similar in terms of how it operates to the way the EU ETS currently operates, thereby making any subsequent linkage that much easier.

Impact on phase 4 negotiations of the EU ETS The negotiations in relation to the next phase of the EU ETS are already under way. Legally, until its exit date, UK representatives in the EU Parliament and the Council of Ministers can be involved in those negotiations without restriction. However, this may not be politically practicable.

It is worth noting that, under Article 50 TUE, the “member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it”. As such, it is likely that the UK would not be able to be part of any discussions that are being reached in parallel about the UK’s ability to link to the EU ETS. Given that the UK may need to follow a policy of selective disengagement, it is also difficult to see the political feasibility of the UK having a persuasive voice in the phase 4 negotiations (although it will still have a vote). This point may be put to the test when the UK decides on how to address its upcoming rotation of the EU presidency in the middle of 2017.

Impact on the Paris Agreement Where parties have not already done so, the Paris Agreement obliges parties to the UNFCCC to submit their nationally determined contributions (NDCs), in advance of the twenty-second session of the conference of the parties to the UNFCCC (i.e., by November 2016). The UK did not submit its own intended NDC in the run up to Paris as its submission was included within that made by the EU on behalf of its Member States. Since the UK may not be part of the EU at the time of the start of the Paris Agreement, as with the separate submissions made by EEA countries, the UK may need to make its own submission to the UNFCCC under the Paris Agreement. For example, Norway submitted its own NDC but stated in that submission that it intended to fulfil its commitments under the Paris Agreement jointly with the EU pursuant to Article 4(16).

It is worth noting that the Climate Change Committee (CCC), established under the UK Climate Change Act 2008, noted¹⁶ that the UK’s statutory target for 2050 is based on a 2°C target and not on the below 2°C target established by the Paris Agreement. However, the CCC did not recommend a tightening of the UK’s fifth carbon budget¹⁷ because it was greater than the EU’s published levels of carbon ambition up to 2030¹⁸ but it did anticipate that the EU would need to increase its ambition levels in the future. There is a statutory obligation on the UK Government to implement the fifth UK carbon budget by 30 June 2016¹⁹.

In addition, the European Union and the 15 Member States that were parties to the Kyoto Protocol when it was signed in 1997 jointly elected to meet their obligations under the first commitment period of the Kyoto Protocol. In order to achieve this, a burden-sharing agreement was entered into by those EU Member States, setting down differentiated emissions limits for each of those Member States with the aim of ensuring that the EU meets its overall 8 per cent reduction commitment under the Kyoto Protocol²⁰. Similar commitments to achieve obligations were jointly made pursuant to an EU decision²¹ between all of the EU Members (and Iceland) following the Doha conference of the parties to the UNFCCC, whereby a second commitment

to the Kyoto Protocol was agreed (**Doha Amendments**). If the exit date of the UK from the EU ETS is prior to the end of the second compliance period of the Kyoto Protocol (i.e., 31 December 2020), the UK may have to meet its obligations under the Kyoto Protocol separately from the EU and the EU may need to revise the burden-sharing arrangements to reflect the absence of the UK's contribution to those efforts. However, we note that the UK is yet to submit its instrument of ratification of the Doha Amendments to the United Nations.

Conclusion To ensure the least possible disruption, it is anticipated that the UK and the EU will negotiate the UK's exit from the EU in parallel with the agreement on its future relationship. However, to do so will probably extend the exit date and so prolong the period of uncertainty in the EU ETS.

In view of this, until the exit date for the UK is known, UK compliance entities as well as active UK non-compliance participants in the EU ETS must continue as they are. However, one of the principal purposes of the EU ETS is to provide a future price signal for the price of carbon. Arguably, that price signal will now reflect this further uncertainty, increasing the downward pressure on EUA prices.

It was observed in the Audit Committee Report that prior to the introduction of EU environmental laws into UK law the UK had the label of the 'sick man of Europe'. However, the UK has, in the more recent past, been a leader in environmental legislation and policy. In terms of climate change, not only has it been ahead of much of the rest of Europe, but it has also been an influential and persuasive voice in brokering and moving forward EU climate policy. Whatever the form of the UK's relationship with the EU after its formal exit, its ability to influence this, at least at the EU level, will clearly be diminished. Given the nature of block or group lobbying at the level of the UNFCCC, the UK's influence will also weaken.

As highlighted by the Audit Committee Report: "There are, therefore, significant unanswered questions about what relationship a UK outside the EU would have with it and with the rest of the world, just as there are unanswered questions as to how our relationship with the EU might develop. Nonetheless, two points were made to us repeatedly. Firstly, the UK would still need to meet international environmental commitments made in the UN and elsewhere, many of which are reflected in EU law. Secondly, a UK outside the EU would still have to comply with some aspects of EU environmental legislation, particularly if it wishes to secure preferential access to the Single Market, but with significantly less ability to influence the process of its development."²²

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- ¹ That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.
 - ² Greenland was a member of the then European Economic Community (a precursor to the European Union). Greenland left the EEC in 1985 after a referendum in 1982. However, at that time there was no Article 50 process.
 - ³ Please note that the UK Government and Parliament would nonetheless have to review all the laws to determine whether they would work in the way intended after the withdrawal is completed.
 - ⁴ Some EU laws, such as EU regulations, have direct effect and do not require local laws to be passed to be implemented. Where that is the case, the UK would need to pass its own laws (if it has not already done so) to fill the void left by the lack of law in that area once the withdrawal period has passed.
 - ⁵ EU and UK Environmental Policy, Third Report of Session 2015-16, 19 April 2016 (**Audit Committee Report**).
 - ⁶ It ran from 2002 and it was closed to new entrants in 2009.
 - ⁷ This assumes the Paris Agreement will have come into force by then. The Paris Agreement will enter into force on the thirtieth day after the date on which at least 55 countries to the United Nations Convention of Climate Change (**UNFCCC**), accounting for at least 55 per cent of total global emissions, have deposited their necessary instruments of ratification, approval etc.
 - ⁸ 'Backloading' is a reference to: Commission Regulation (EU) No 176/2014 of 25 February 2014 amending Regulation (EU) No 1031/2010, in particular to determine the volumes of greenhouse gas emission allowances to be auctioned in 2013-20, whereby 900 million EU allowances due to be auctioned in 2014-16 were taken out of the EU ETS auction volume, to be reinstated in 2019-20.
 - ⁹ Decision (EU) 2015/1814 of the European Parliament and of the Council of 6 October 2015 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC.
 - ¹⁰ Under the MSR, the 900 million allowances under Backloading will be transferred to the reserve rather than auctioned in 2019-20. Unallocated allowances will also be transferred to the reserve. Although the precise number will only be known in 2020, it is estimated that between 550 and 700 million allowances could remain unallocated by 2020.
 - ¹¹ Currently this is only relevant in relation to the UK's compliance with its obligations for the second commitment period of the Kyoto Protocol.
 - ¹² The thirty-ninth assembly of the International Civil Aviation Organization will meet in Montreal from 27 September to 7 October 2016.
 - ¹³ This establishes binding annual greenhouse gas emission targets for Member States for the period 2013-20.
 - ¹⁴ Annex 1 to Decision No 406/2009/EC of The European Parliament and of The Council of 23 April 2009 on the effort of Member States to reduce their greenhouse gas emissions to meet the Community's greenhouse gas emission reduction commitments up to 2020.
 - ¹⁵ In 2007, the Joint Committee of the European Economic Area agreed to incorporate the Emissions Trading Directive 2003/87/EC and a number of implementing provisions into the Agreement on the European Economic Area. If the UK joined the EEA, this agreement would require the UK to incorporate the EU ETS into its law.
 - ¹⁶ In its letter of 28 January 2016 to the Secretary of State for Energy and Climate Change setting out how the outcome of the Paris Agreement affects the CCC's advice on the recommended level of the fifth carbon budget.
 - ¹⁷ For the period 2028-32.
 - ¹⁸ The EU commitment is to reduce emissions by 40 per cent by 2030 compared to 1990 levels. In contrast, on the basis of the CCC's recommendation, the UK's fifth carbon budget will be equivalent to a 57 per cent reduction against 1990 levels by 2030.
 - ¹⁹ Section 4 of the Climate Change Act 2008 requires that the set carbon budget levels must be fixed in legislation "not later than 30th June in the 12th year before the beginning of the period in question".
 - ²⁰ The limits in the burden-sharing agreement (2008-12) are expressed in terms of percentages by which Member States must reduce, or in some cases may hold or increase, their emissions compared with the base-year level (1990).
 - ²¹ Council Decision on the conclusion, on behalf of the European Union, of the Agreement between the European Union and its Member States, of the one part, and Iceland, of the other part, concerning Iceland's participation in the joint fulfilment of commitments of the European Union, its Member States and Iceland for the second commitment period of the Kyoto Protocol to the United Nations Framework Convention on Climate Change; 10883/5/14 REV 5.
 - ²² P.29 of the Audit Committee Report.

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