CURTIS

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ENVIRONMENTAL CLIENT ALERT

MANDATORY GREENHOUSE GAS EMISSION REDUCTION REQUIREMENTS & PERMIT TRADING IN EUROPE: ASSESS YOUR RISK & OPTIMAL STRATEGY

INTRODUCTION

On January 1, 2005, approximately 15,000 carbon dioxide emissions sources in 28 European countries will, for the first time, face mandatory greenhouse gas ("GHG") emission reduction requirements and will be able to trade GHG emission permits under a new European carbon dioxide control program. Beginning in 2008, these sources also will be able to use and trade in the European system credits for GHG emissions reductions from projects outside of Europe.

Operators of sources affected by these regulations should act now to assess their risk and develop a trading and investment strategy to optimize their position under the new trading regime.

WHO MUST COMPLY?

The program is broad in scope and will regulate emissions from carbon dioxide emission sources in the economic sectors indicated in the following table.

CO_2 EMISSION SOURCES REGULATED BY THE EUROPEAN PROGRAM	
ENERGY √ Combustion, including power, heat, and steam generation with 20MW or more of thermal input, aggregated from all on-site activities √ Mineral oil refineries	**IRON AND STEEL** √ Ore √ Pig iron and steel production with capacity greater than 2.5 tons per hour √ Coke ovens
MINERALS √ Cement, over 500 tons per day using the clinker process √ Cement, over 50 tons per day using lime or non-rotary furnace processes √ Glass, over 50 tons per day √ Ceramics, over 75 tons per day	**OTHER** √ Paper, over 20 tons per day √ Pulp

WHAT IS THE SCHEDULE?

> The program begins with a three-year "warm-up" compliance period from 2005 to 2007 and, beginning in 2008, then segues to consecutive five-year compliance periods.

> The 15 European Union member states[1] and the three European Economic Area countries[2] must enact implementing legislation by December 31, 2003.

> By March 31, 2004, participating states must publish plans for allocating permits to emit carbon dioxide to sources in the covered sectors and must finalize such allocations by October 1, 2004.

> The 10 countries[3] currently in the process of joining the Union must have the program in place when they join in 2004.

> At some time after the final allocation of permits by participating states but prior to January 1, 2005, operators of sources must apply for permits to emit carbon dioxide.

> Beginning on January 1, 2005, no covered source may emit carbon dioxide without a permit.

HOW WILL THE PROGRAM WORK?

Sources must apply for carbon dioxide permits to the state in which the source is located. The application will have to describe the source's

1) activities;
2) raw materials used;
3) sources of emissions of carbon dioxide; and
4) measures planned to monitor and report emissions according to upcoming Union guidelines.

Participating states will issue one permit per ton of carbon dioxide emissions to sources for the relevant compliance period based on the state's permit allocation plan. The total number of permits that will be allocated to a source will be based on the source's historic carbon dioxide emissions. Permits for the subsequent five-year compliance periods will be allocated at least one year prior to the beginning of each period. States are directed to take into account in their allocation plans the need to provide access to permits for new and expanded sources. Ultimately, however, states will allocate permits in a manner that will contribute to the reduction in total GHG that the state must make in order for the Union to comply with its commitment under the Kyoto Protocol to reduce GHG emissions 8% below 1990 levels by 2012.[4]

In the warm-up period, participating states will provide 95% of the total permits to sources free of charge. It is presumed that participating states will auction the remaining permits, but states retain discretion regarding the method of distribution. In the first five-year compliance period beginning in 2008, participating states may provide up to 90% of the total number of permits free of charge.

Permits will be freely transferable. Permit holdings and transactions will be tracked both at the participating state level and at the Union level and the information will be available to the public. Sources will be required to annually report their emissions to the appropriate state according to the methods described in their permit application. By April 1 of each year, sources will be required to surrender to the participating states sufficient permits to account for their emissions of carbon dioxide in the previous calendar year. If a source does not have sufficient permits to cover its actual emissions, the source will have to either acquire additional permits in the market or pay a penalty and surrender additional permits to make up of the shortfall in the following year. Penalties range from 40 Euros per ton in the warm- up period to 100 Euros per ton in the subsequent compliance periods. In addition, source's names will be published as violators of the law.

Beginning in 2008, participating states or sources will be able to comply with European emission reduction requirements by using emissions credits from projects that reduce GHG emissions, such as renewable energy projects, in non-European states that have ratified the Kyoto Protocol.

WHAT WILL THE NEW EUROPEAN CARBON DIOXIDE PERMIT MARKET LOOK LIKE?

By any measure, the European market resulting from this program will be significant. When fully implemented, the program will cover an estimated 15,000 sources emitting some 1.5 billion tons of carbon dioxide annually. Compare this to 445 sources emitting approximately 8.5 million tons of sulfur dioxide under the U.S. program controlling sulfur dioxide emissions from power plants. Union officials estimate that the aggregate annual compliance costs for the European program will range from 2.5 to 3 billion Euros and that the average price for a carbon dioxide permit in 2005 could be approximately 10 Euros per ton.

WHAT SHOULD COMPANIES DO NOW?

Companies that own or operate potentially covered sources should begin preparing for this new program now by taking the following steps:

1. Determine whether their facilities contain sources that are covered by the program:
   - > Is the source in one of the economic sectors or categories covered by the program?
   - > Do the source's inputs or outputs exceed the applicable thresholds for that category?
   - > When answering these questions, keep in mind that the combustion category is exceptionally broad and applies to any aggregation of boilers at a facility, except for hazardous and municipal waste installations, with a total thermal input exceeding 20 megawatts.
2. Estimate the source's annual carbon dioxide emissions.
3. Review the implementing legislation and allocation plan in the jurisdiction where the source is located to determine the potential number of permits that may be allocated to the source.
4. Begin gathering the information required to prepare an application to receive permits for the source.
5. Estimate the source's likely position in the market:
   - > Will the source have excess emissions permits to sell or will it be required to reduce emissions in order to comply?
   - > Will the source comply by reducing its emissions or by purchasing additional permits?
   - > How does the program and trading of permits affect the company's expenditure plans, tax position, and other financial considerations?
6. Begin to evaluate whether to invest in emission reduction projects in other Kyoto Protocol participant countries, either through direct investment or through investment in a fund that finances such projects and distributes emissions credits to members.

WHAT SHOULD COMPANIES DO THAT WANT TO EXPAND OR LOCATE NEW COVERED SOURCES IN EUROPE?

The new program places a cap on carbon emissions from covered sources. Beginning on January 1, 2005, new as well as expansions of existing sources of emissions in Europe will have to procure credits before they can operate. The program requires that participating states provide new or expanded sources access to permits, but the program provides participating states no guidance as to how to provide such access. How states will implement this requirement is unclear. However, it is likely that, before new or expanded sources can operate, they will be required to purchase at least some permits on the open market, much like new or expanded sources of emissions of nitrogen oxides or particulate matter must purchase emissions credits in certain areas of the United States. Companies will have to

incorporate such purchases into their planning for the location and timing of construction of new or expanded carbon dioxide sources in Europe.

[1] *Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom.*

[2] *Norway, Iceland, and Liechtenstein.*

[3] *Poland, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Slovakia, Slovenia, Romania, and Bulgaria.*

[4] *The European Union appears intent on implementing its program regardless of the entry into force of the Kyoto Protocol.*

FOR FURTHER INFORMATION, PLEASE CONTACT:

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