

Energy Law Update

Key elements of the European Commission's policy framework for climate and energy in the period from 2020 to 2030

KINSTELLAR

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Preface

KEY ELEMENTS OF THE EUROPEAN COMMISSION'S POLICY FRAMEWORK FOR CLIMATE AND ENERGY IN THE PERIOD FROM 2020 TO 2030

Kinstellar's Energy Law Update provides a timely overview of recent developments in energy policy and energy market regulation in Central, Eastern and Southern Europe, Turkey and Central Asia.

In addition to regulatory updates, reports on market and legislative developments, our Energy Law Update also presents our experts' views gained from their deep knowledge of the energy markets in Emerging Europe and Central Asia. As such, it has an element of subjectivity – which we hope will make it interesting for our readers.

If you have any questions or comments regarding this newsletter, please do not hesitate to contact us.

This newsletter provides concise information on certain topics. Its content is not necessarily exhaustive and should not be considered as legal advice. If you have any questions in relation to the content of this newsletter, please feel free to contact us and we will be more than happy to assist you.

In this issue:

- New greenhouse gas emissions target and reform of the EU ETS
- New EU-level renewable energy target for 2030
- Coordination of Member States energy policies
- Determination of minimum principles for the exploration and production of unconventional hydrocarbons
- Implementation of energy efficiency objectives
- Assessment of EU energy prices

2030 Energy and Climate Package



There were great expectations following the European Council's energy policy conclusions of May 2013 and the European Commission's (the "**Commission**") communication on energy market that followed in November. On 22 January 2014, the Commission finally published a new package of energy and climate proposals in the period from 2020 to 2030 (the "**2030 Energy and Climate Package**").

The new package makes it clear that the Commission still regards sustainable, competitive, low-carbon and secure energy supply as the main objective of the European Union's ("**EU**") energy policy. More specifically, the Commission frames the achievement of EU energy policy objectives around the following main elements:

- new greenhouse gas emissions reduction target for 2030 and reform of the EU ETS;
- new EU-level renewable energy target for 2030;
- new governance system for national energy policies;
- promoting the security of energy supply and, in this context, the regulation of exploration and production of unconventional hydrocarbons;
- full implementation of the energy efficiency objectives;
- ensuring energy market competition;
- competitive, affordable and reliable EU energy supply.

The 2030 Energy and Climate Package should be considered as the Commission's proposals, which will come up for a detailed discussion primarily with the European Parliament and with the European Council in the near future. In this negotiation procedure, the energy policy conclusions expected to be formulated at the European Council's meeting on 20-21 March 2014 would be the first milestone.

In this newsletter we briefly review and comment on some aspects of the 2030 Energy and Climate Package.

Key components of the 2030 Energy and Climate Package

The proposed key measures are found in the following set of related documents:

- Communication from the Commission on a policy framework for climate and energy in the period from 2020 to 2030 (the “**Energy Policy Communication**”);
- Communication from the Commission on the main conclusions of an EU-wide analysis of energy prices and costs (the “**Energy prices Communication**”);
- Proposal to the European Parliament and European Council for decision on the establishment and operation of a market stability reserve and amendment to Directive (EC) No. 87/2003 (the “**Market Stability Reserve Proposal**”);
- Communication from the Commission on exploration and production of unconventional hydrocarbons (such as shale gas) using hydraulic fracturing (the “**Unconventional Hydrocarbons Communication**”) and related recommendation on the minimum principles for the exploration and production of unconventional hydrocarbons (the “**Recommendation**”).

The Commission’s communication on a framework for state intervention in energy markets (the “**State Intervention Communication**”), published in November 2013, is another noteworthy document in the context of the EU energy policy which was analyzed in one of our previous newsletters.



New greenhouse gas emissions target and reform of the EU ETS

With respect to greenhouse gas emissions, the Commission is proposing a reduction target of 40% in 2030 relative to 1990 levels. The new target, which doubles the current 20% reduction, would be allocated among Member States in the same way as under the current system.

The Commission proposes to share the 40% target between the EU Emission Trading System (“**ETS**”) sector and non-ETS sector, which would amount to reduction targets of 43% and 30% respectively in 2030.

In addition, to reinforce the ETS’ role and increase its effectiveness, the Commission is proposing the following measures:

- increase the annual linear reduction factor from the current 1.74% to 2.2% between 2020 and 2030;
- limit the charging of emissions reduction allowances from international emissions reduction mechanisms in the EU ETS sector; and
- establish a market stability reserve (the “**Market Stability Reserve**”) operating as of the fourth trading period in 2021 based on a set of predefined rules and principles.

The Market Stability Reserve is a structural measure that aims at resolving the problem of oversupply of allowances in the EU carbon market and preventing future accumulation. More specifically, in each year beginning in 2021, a proportion of the total number of allowances would be placed in the Market Stability Reserve, subject to a minimum threshold. In any year, a number of allowances would be released from the Market Stability Reserve if the total number of allowances in circulation is lower than a pre-determined level. The allowances so released would then be auctioned by Member States based on current rules. The adjustment mechanism would work automatically, based on a set of pre-defined criteria.

With a view to mitigating the potentially disruptive impact on the ETS market of the back-loading mechanism, which may result from the reintroduction at the end of the third trading period of the 900 million allowances withdrawn now, the Commission proposes that two-thirds of that surplus of emission allowances in the last year of the third period be added in equal instalments to the volumes to be auctioned in the first two years of the fourth period.

New greenhouse gas emissions target and reform of the EU ETS (cont.)

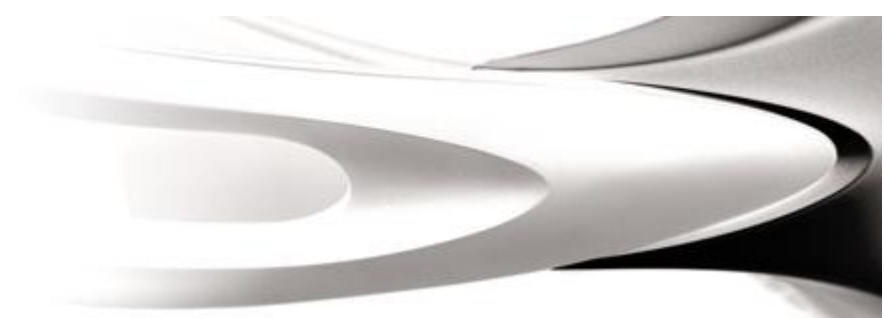
Kinstellar comments:

There will be tough negotiations at the European Parliament and Council levels before the proposals submitted by the Commission can be adopted. The Commission invited the European Parliament and the Council to formally adopt the greenhouse gas emissions reduction target of 40% by the end of 2014, but it is doubtful whether this can be achieved in an election year.

Furthermore, it is questionable whether the Commission can succeed in the adoption of the Market Stability Reserve in addition to back-loading, and whether the mechanism will effectively alleviate the structural problems identified by the Commission.

It is important that the legislation set out in the Market Stability Reserve Proposal establishes an automatic adjustment mechanism which excludes the possibility of the EU or Member States' discretionary intervention in the operation of the ETS.

Regarding the future of the ETS, it will be interesting to see whether a global climate agreement can be concluded in 2015, and if so, which targets individual Member States will commit to. The Commission calls for the early adoption of its proposals having regard in part to this negotiation process.



New EU-level renewable energy target for 2030

The Energy Policy Communication stresses that renewable energies should continue to play a fundamental role in the establishment of a competitive, sustainable and secure energy supply. In the Commission's view, a market-driven approach should be applied in the field of renewable energy policy.

In the Commission's opinion, subsidies for mature renewable energy technologies should be phased out in the period of 2020 to 2030, while subsidies for immature technologies that have great potential in terms of their cost-effectiveness would still be allowed. New state aid guidelines, currently being finalised, should provide guidance on the compatibility of renewable energy aid systems with EU law.

Regarding the share of renewable energy consumed in the EU, the Commission proposes a target of 27%. The Commission expects the share of renewable energy in the electricity sector to rise to 45% by 2030.

Pursuant to the Commission's proposal, as opposed to the current binding national renewable energy targets, the EU-level target would not be translated into binding Member State targets.

As Member States' targets would not be determined at EU level, the Commission intends to leave them with greater flexibility. However, Members States would be expected to commit collectively to attaining the EU renewable energy target, and the Commission would limit their autonomy by introducing a new governance framework to ensure coordination of their energy policies (discussed below).



New EU-level renewable energy target for 2030 (cont.)

Kinstellar comments:

Making the new renewable energy target of 27% of total energy consumption binding on the EU only shows a necessary compromise in light of Member States' opposition to binding renewable energy targets.

However, the new governance framework proposed by the Commission, which introduces measures to coordinate Member States' energy policy objectives and national plans, may compromise not only Member States' autonomy but also the rigorous approach of the Commission.

Finally, the Commission's proposal that state aid be phased out in respect of mature renewable energy technologies after 2020 means that such investments will have to be viable on their own.



Coordination of Member States energy policies

In the Energy Policy Communication, the Commission proposes enhanced coordination of Member States' energy policies, which are expected to prepare new national plans for the period after 2020 in accordance with detailed guidelines from the Commission. Member States will be expected to set out a clear approach to achieve domestic objectives for greenhouse gas emissions, renewable energy, energy efficiency and energy security. In addition, important developments affecting the national energy mix, such as nuclear or unconventional hydrocarbons, as well as policies affecting directly or indirectly the energy sector (e.g. tax or subsidies), will have to be included.

Member States will be expected to consult with neighbouring countries in the preparation of their national plans to ensure regional cooperation. National plans should thereafter be submitted to the Commission to ensure compatibility with the EU's climate and energy policy and state aid rules.

The Commission expects national plans to be adopted well before 2020 within the framework of the new governance system in order to give adequate notice to potential investors in the EU energy markets.

Kinstellar comments:

The Commission's proposals suggest a trend towards a significantly more centralized EU energy policy.

The extent of the Commission's role in reviewing and assessing national plans is not clear. From reading the Energy Policy Communication, it is obvious that national plans will not simply set out measures to attain renewable energy targets, but more broadly incorporate all key elements of a country's energy policy. As a result, the Commission may exercise some control over Member States' national energy policies through review and assessment (perhaps approval?) of national plans.

Determination of minimum principles for the exploration and production of unconventional hydrocarbons

In accordance with the European Council's energy policy conclusions of May 2013, which called for the exploration and development of indigenous energy sources to reduce the EU's import dependency, the Commission believes in the potential of hydrocarbons such as shale gas using hydraulic fracturing.

The Commission notes the EU's significant reserves of unconventional hydrocarbons, with shale gas having the highest potential. The Commission estimates, in a best case scenario, that the overall share of unconventional hydrocarbons could represent approximately 3% of the EU energy mix by 2030.

The Unconventional Hydrocarbon Communication reviews the potential of shale gas in the EU, the environmental risks and public safety concerns linked to its extraction, and introduces a proposal for an EU framework for shale gas exploration and exploitation.

Noting that the existing EU legislation has not rendered enough clarity to the standpoint of the EU, the Commission has adopted the unconventional hydrocarbons Recommendation, which outlines the minimum principles Member States engaged in shale gas exploitation should comply with. These principles pertain, inter alia, to environmental and risk assessment, reporting, public information, as well as technical considerations (insulation, ventilation, etc.).

With the adoption of the Commission Recommendation the Commission still leaves it to the Member States to decide whether they would utilize shale gas in their territory, provided that they comply with the minimum requirements laid down in the Recommendation. The Commission stressed that the Recommendation does not yet constitute new legislation and the existing EU legislation should still be applied by the Member States. However, the fact that the Commission's Recommendation now set forth in detail the minimum requirements for exploration and production of shale gas using hydraulic fracturing may indicate the future adoption of shale-gas specific new legislation in this area. This question will be analyzed in a separate newsletter.

The Commission will review the Recommendation's effectiveness 18 months after its publication and determine whether legislative proposals should be put forward to improve it.

Kinstellar comments:

Although the unconventional hydrocarbons Recommendation is not legally binding, it contributes significantly to clarifying the rules governing the exploration and extraction of unconventional hydrocarbons in the EU.

Implementation of energy efficiency objectives

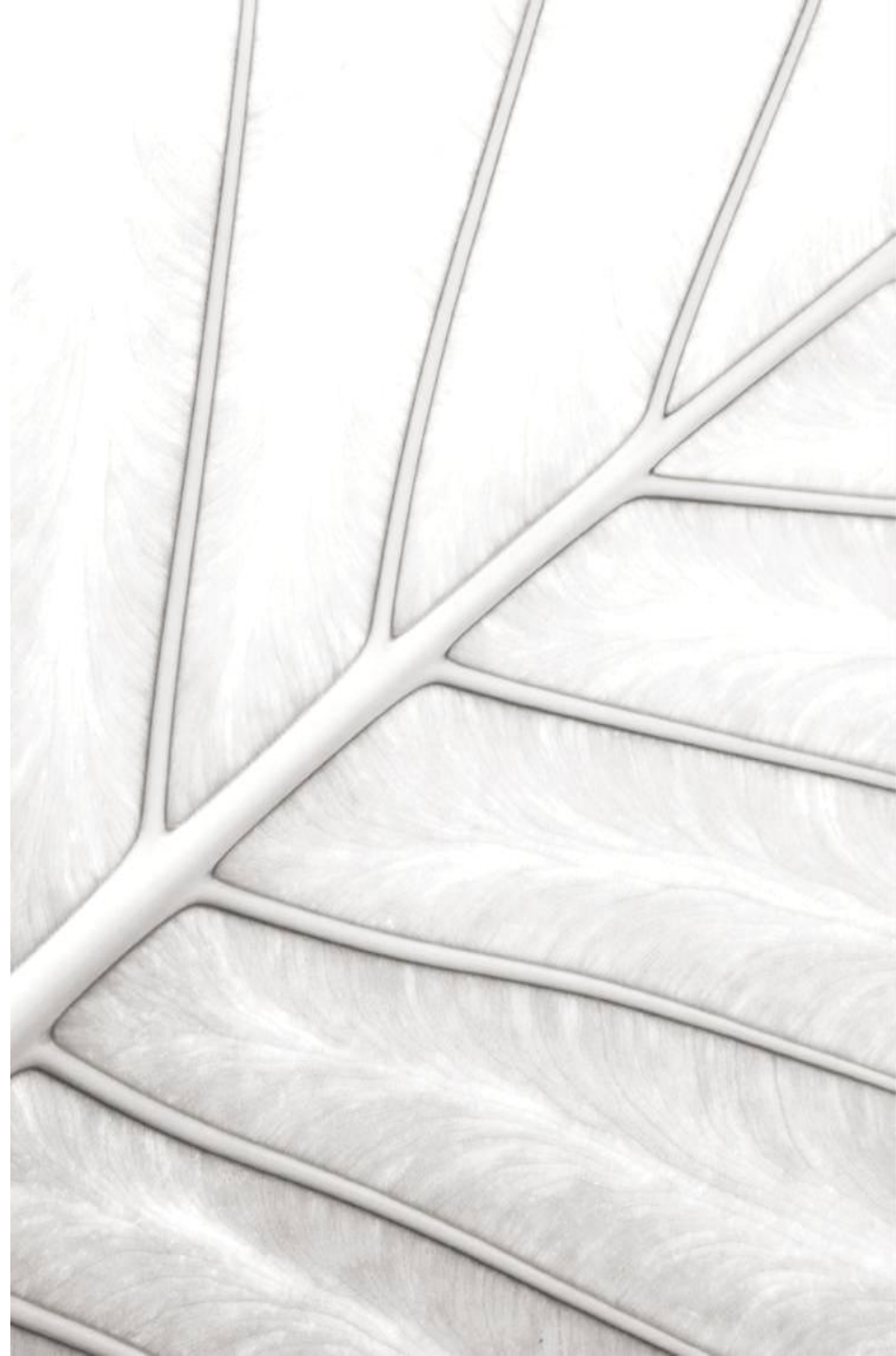
In the Energy Policy Communication, the Commission underlines the important contribution of greater energy efficiency to the objectives of the EU climate and energy policy. Although the deadline for implementing the Energy Efficiency Directive is not before June 2014, the Commission will by mid-2014 assess progress towards reaching the 2020 target and consider whether amendments should be proposed.

The Commission notes that improvements observed in some sectors, such as vehicles, must continue, whereas current efforts should be intensified in others, such as housing and electronic equipment, and mentions the need to introduce EU-wide energy efficiency standards.

Kinstellar comments:

The 2030 Climate and Energy Policy Package is silent on the issue of assessment of energy efficiency efforts and the eventual adoption of further measures.

The Commission wishes to address this issue when it reviews the Energy Efficiency Directive in mid-2014. However, the Commission points out that the greenhouse gas emissions reduction target of 40% assumes that energy savings level should increase by cca. 25%.



Ensuring competition in the energy market

The Commission underlines in the Energy Policy Communication that the establishment of an integrated internal natural gas and electricity market remains a priority. The Commission maintains the view that a competitive internal energy market is necessary to achieve the EU's energy policy objectives cost-efficiently.

The Commission refers to the State Intervention Communication and accompanying state aid guidelines and stresses the necessity of enhanced competition in the retail trade segment.

Kinstellar comments:

The Energy Policy Communication suggests that the Commission is aware that the establishment of an integrated internal market will not be achieved by the 2014 deadline prescribed by the European Council.

In spite of the expected delay and Member States' concerns, the Commission considers the establishment of an integrated internal market as its primary task.

It should be noted that state intervention in the EU energy market gained broad ground in the past, hampering the development of an integrated internal market. However, the Commission has not taken any new measures to speed up the development of the internal market.



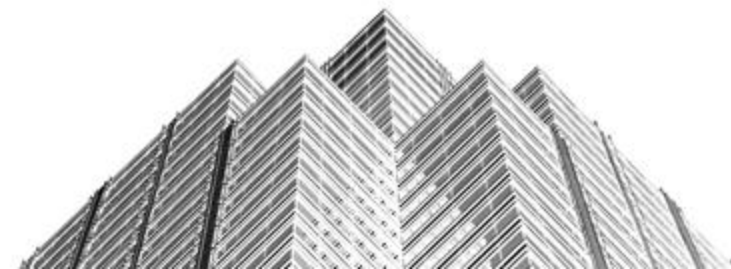
Assessment of EU energy prices

In the Energy Prices Communication prepared at the request of the European Council, the Commission analyses the reasons for rising energy prices and costs in Europe, the energy price gap between the EU and some of its main trading partners (US, China, India), and the short and long term impact on EU industry and households. The Energy Prices Communication makes the following observations:

- The rise in energy prices in the EU was primarily driven by increases in taxes and levies, as well as network costs, whereas the energy element of the price fluctuated, which suggests that the internal energy market was not functioning properly;
- Member States follow different policies in terms of energy pricing, which, in practice, segregate the internal energy market. This is made worse by the fact that the composition of national energy prices, such as plug-in taxes and other levies, and the national regulation of the network costs element are not transparent.

- Therefore both households and industry are facing rising energy costs, with the latter – especially energy-sensitive industrial consumers – suffering competitive disadvantages.
- Innovative solutions such as smart metering technology have not found their way to most European households, in part because of the economic recession.

In addition, the Commission deems it necessary to review national policies regarding the tax and levy element of energy prices, based on guidance set out in the State Intervention Communication.



Assessment of EU energy prices (cont.)

Finally, the Commission underlines that fiscal measures such as exemptions and reductions in taxes and levies may be appropriate to protect some energy-sensitive industrial consumers from rising energy costs, thus maintaining their competitiveness, provided that these measures comply with EU state aid rules.

The Commission draws attention to the proposed revised State Aid Guidelines regarding energy markets (currently in public consultation), which would allow Member States to grant partial compensation for additional costs to some industrial consumers in order to maintain the renewable energy support level and avoid the risk of carbon leakage.

Kinstellar comments:

In the Commission's view, the solution to the various problems outlined above lies clearly with the completion of the internal market and the further development of energy infrastructure. In addition to sustaining market liberalization, the Commission continues to support competition and investment in energy. The Commission intends to publish a communication on retail markets in the spring.

As a word of caution, the Commission stresses the importance for Member States to follow best practices regarding the levy and tax component of the price, including the Commission's guidance set out in the State Intervention Communication.



Contact

Andr k  Kinstellar  gyv di Iroda

Akad mia Bank Center
Sz chenyi rakpart 3.
1054 Budapest

Switchboard: + 36 1 428 4400
Facsimile: + 36 1 428 4444
Web: www.kinstellar.com

Dr. Krist f Ferenczi

Partner, Firm-wide Head of Energy

T: + 36 1 428 4471

E: kristof.ferenczi@kinstellar.com

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The firm was formed in November 2008 from the **Bratislava**, **Bucharest**, **Budapest** and **Prague** offices of Linklaters and has expanded with new offices in **Belgrade** and **Istanbul** and from September 2013 in **Almaty**, Kazakhstan. Kinstellar's experience speaks for itself: major corporations, financial institutions, governments and the most respected international law firms trust us because we deliver.

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