

Why Russia fails to convert hot air into cold cash

# Moscow turns cold shoulder to Kyoto

As a result of its economic decline in the 1990s, Russia has billions worth of CO<sub>2</sub>-emission credits to sell to European governments and companies. But no sales are being made, because Moscow cannot - or will not - get the required procedures in place. The Russian indifference to Kyoto means that everyone loses: Russia itself, the EU and planet earth.

| By Jeroen Ketting

The life of the Kyoto protocol hung in the balance for a long time. It was only saved by the Russian ratification of the accord in February 2005. For the protocol to come into force, developed nations representing at least 55% of global greenhouse emissions had to ratify it. With the United States, accounting for just over a third of global emissions, pulling out in 2001, the combined emissions of developed nations that had ratified the protocol came down to only to 44%. Russia's 17% emissions was, therefore, a lifesaver to the global community.

As everyone knows, the Kyoto protocol requires participating countries to jointly cut back greenhouse gas emissions in the period of 2008-2012 to 5 percent below the level of their 1990 emissions. Russia negotiated a zero percent reduction commitment, effectively establishing its 1990 level as the upper limit of its allowed emissions. Today, Russia's emissions are about 33% below its 1990

level. This was caused by the decline of industrial output in Russia in the 1990s after the demise of the Soviet Union. Consequently, for Russia, meeting its Kyoto obligations will not be a problem. On the contrary. In spite of the fact that its emissions are already lower than the 1990 level, most experts agree that there is still a great greenhouse gas emissions (GHG) savings potential in Russia. The country is regarded as the largest potential host for so-called Joint Implementation projects in the world.

The Kyoto protocol provides three flexible market mechanisms - Joint Implementation (JI), Emissions Trading and the Clean Development Mechanism (CDM) - that countries can use to cooperate on reaching their emissions reduction targets. CDM is especially set up for emissions reduction projects that countries with a reduction can carry out in developing countries that do not have a reduction target under the treaty. This does not apply to Russia.

JI and Emissions Trading can be used between countries that do have reduction targets. Countries and companies that are required to reduce their emissions can do this by carrying out JI-projects in countries that have an excess of allowances, like Russia, or they can buy credits in other countries. These market mechanisms were created to make emission reduction cheaper. Both instruments can be used very well in attracting foreign investment in order to make Russia more energy efficient.

The former Soviet economic system was extremely energy-intensive, partly because of the abundance of energy resources. The potential for improvement has not been tapped up to this day. In fact, the drop in energy consumption since 1990 has lagged behind the decline in economic activity. In other words, the energy intensity of the Russian economy has increased. Russia's energy use per unit of GDP is 3.1 times the level in the 15-country EU before the enlargement. Some 25% to 30%



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of this difference can be attributed to the cold climate, but the rest of it is caused by sheer inefficiency. Coal fired power generators and district heating plants, oil refineries, metallurgical and chemical plants are the worst polluters. The harsh Russian climate, the energy intensity of the Russian industry and overall inefficiencies in the entire energy value chain cause Russia's energy consumption to have a more negative impact on the environment than is the case in developed countries. This could even get worse. To achieve a more balanced fuel mix and to have more gas available for export, Russia might choose to make greater use of its coal reserves. Burning larger volumes of coal would eat up most of Russia's available emissions credits and might even bring the country's emissions above the 1990 level. In the coming years, huge investments are needed in the Russian energy sector and the industrial sector in order to secure efficient generation, distribution and consumption of energy in the future. According to the Russian Energy Strategy 2020, as formulated in 2004, the total investments needs of the Russian energy sector amount to \$500 billion for the period to 2020 to secure a reliable and efficient energy production for domestic consumption and export.

## Hypothetical |

As Russia is likely to stay below its Kyoto target limit agreed in 1997, its surplus

emission allowances could be sold on the international market for emission reductions to other industrialized countries that have not achieved the necessary emissions reductions. Whereas Japan, Canada and the EU are large potential buyers, Russia is one of the largest suppliers of surplus emission credits on the international emissions trading market. It has been estimated that in a global emissions-trading system that includes the US, the value of those Russian reductions could be as high as \$3 billion. This puts Russia in the position of a potentially very large recipient of greenhouse gas mitigating investments. Russia is particularly attractive for investment in emission reduction schemes because it is relatively easy to improve energy efficiency in the country. Experts therefore sometimes refer to the potential Russian emission credits as 'hot air'.

In spite of the huge opportunities, however - both for Russian organizations wishing to sell credits and for European companies and governments wishing to buy them - and despite the fact that more than 50 JI-projects have already been devised and submitted for approval to the regulatory body, the UNFCCC (United Nations Framework Convention on Climate Change), not a single Russian JI-project has as yet been formally approved. The reason is that

the Russian government has not yet put the institutional framework in place that is required for the UNFCCC for the approval and monitoring of projects.

In order to carry out emissions trading and joint implementation projects an efficient domestic institute for controlling emissions from various sources and a reliable monitoring and reporting system must be put in place. At the moment it is not yet clear which institutions in Russia have the authority to take on this role. It has not been decided which Russian governmental body would be the designated national authority that issues letters of approval of JI-projects. In addition, various other administrative issues relating to applications for approval of JI-projects in Russia and verification of emissions reductions need to be resolved. As a result, many foreign governments regard their plans to implement Kyoto projects in Russia as no more than hypothetical.

Some of the other fundamental issues that need to be regulated before potential foreign and Russian investors will become involved in Russian JI-projects concern the ownership and passing of title to Russian JI-credits, the issuance and delivery of those credits, and the appropriate contractual and payment mechanisms. As Russia, for example, regards JI-credits generated by projects

based in Russia to be a state asset, only capable of being transferred between states, it is not clear whether foreign investors will be able to receive 'emission reduction allowances' (i.e. credits) directly from Russian companies or even directly from the Russian government.

On 28 May 2007, the Russian government published Decree No. 332 in relation to the procedure for approval and verification of Russia-based JI projects. Yet this decree fails to resolve the many legal and practical barriers to successful JI investments in Russia. Although the decree to some extent resolves some aspects of how the Russian JI project approval process will work in practice, it fails to address one key issue and raises a new concern. First, it does not describe the process of receiving the letter of approval from the Russian government

rather a consequence of economic and trade interests and careful political calculation. First of all, Russia's ratification had a direct connection with the EU's approval of Russia's WTO bid. 'We are for the Kyoto process', Putin said during a news conference after a summit with European leaders in May 2004. 'We support it, although we do have some concerns over the obligations that we will have to assume. The European Union has met us halfway in negotiations on the WTO, and it could not help but have a positive effect on our attitude toward ratification of the Kyoto protocol.' One of the main points of contention in the WTO negotiations between Russia and the EU had to do with the price of natural gas. European companies feared Russia would have a competitive advantage because of its cheap natural gas. The chemical industry, in particular,

regarding its Chechnya policy.

In addition to these three factors the rise in oil prices was important in overcoming the Kremlin's aversion to the Kyoto protocol. Many in the Russian government feared that the obligations of the Kyoto Protocol would hamper economic growth. The burgeoning oil bonanza did much to increase Russia's confidence and alleviate the fears of the Protocol's potentially adverse economic effects.

It is obvious that Russia's ratification had little to do with environmental concerns. Most of the reasons that motivated Russia to ratify do not play a role anymore today. The history and background of Russia's ratification of the Kyoto protocol helps to explain why the country has not made any headway with the conditions for the protocol's implementation. The Russian Ministry of Economic Development and Trade (MEDT) was the most vocal and constructive advocate of the Kyoto Protocol. But with the replacement of the MEDT's long-serving 'liberal' minister, German Gref, as well as the, for Kyoto, not less important vice-minister Sharonov, the movement towards implementation of the Protocol's flexible mechanisms in Russia was decapitated.

Now, with the upcoming Presidential elections in March 2008 it is not to be expected that any progress will be made towards the establishment of the conditions necessary for Kyoto. Only when the new President will be firmly in his seat and when the new administration will be appointed may we expect any changes.

But apart from political and economic considerations, there are factors that help to explain why the implementation of JI projects or emissions trading is not making any headway in Russia. Even if the administrative and regulatory framework will be put in place, there are a lot of other problems that the JI investor will have to overcome. For example, almost 40% of the projects that have been submitted to the UNFCCC concern the reduction of methane emissions in gas distribution networks. The Kyoto

Protocol states that for a JI project to be approved the reduction it achieves needs to be additional to the reduction that would otherwise occur. However, Russian regulations with regard to gas distribution state that gas distributors already have the obligation to maintain a zero level of methane leakage. Even if the UNFCCC decides to overlook the fact that formally methane emissions projects at gas distribution networks fail to meet its own additionality criteria, the management of these, often municipal, gas distributors will be hesitant to admit that any substantial leakages occur. This is just an example of how formal Russian regulations collide with the principles of the Kyoto protocol. Moreover, it is technically very easy, when establishing a baseline for leakage from a gas distribution network to manipulate the volume of leakage by just loosening or tightening flanges.

In order to deal with the UNFCCC's requirements concerning baseline setting and monitoring during a project's implementation period from 2008 to 2012, a rather sophisticated management system has to be in place at the organizations where the actual emission reductions are to be achieved. Most of the gas distribution companies as well as most of the Russian District Heating Companies (that account for about 10% of the projects submitted to UNFCCC) have organizational structures and management systems that have their roots in the Soviet period. They are simply not capable of dealing with the reporting requirements of the UNFCCC. The management of municipal gas distribution companies and district heating companies is often politically appointed. Also the budgets of these municipal organizations are decided upon on a year to year basis. As a result, only in rare cases will the same management be in place during the entire implementation period (2008-2012) and it will be hard to guarantee fixed budget spending on efficiency improvements during this five year period.

All in all this means that at least some 50%

of the projects listed by the UNFCCC are based upon a very insecure foundation.

The low level of awareness of the Kyoto Protocol and its mechanisms and a complete lack of interest in energy efficiency has its own problems. Many people in Russia have overblown expectations of the financial gains that may result from JI projects. Having heard and read about the billions of dollars or euros that can be earned through JI, many officials and managers engage in JI initiatives merely out of short term financial gain and not out of environmental concern. Many in Russia compare the opportunities of the Kyoto



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protocol with the internet bubble of the nineties. They do not realize that real JI gains will not come so easily.

#### Substantial risk |

In short, there are a great many impediments to realizing JI projects in Russia. If these impediments are not removed, foreign investments in Russian JI projects will be held back and the opportunity to generate revenue and cut domestic energy consumption will not be capitalized upon. This will hurt the global environment and the Russian economy, because more domestic demand of oil and gas means more emissions and less exports of oil and gas - the foundation of Russia's recent economic growth.

The potential failure of the Kyoto protocol in Russia will also have consequences for

Europe. A constrained supply of Russian gas will mean higher prices. Even if European consumers will be forced to use energy more efficiently, any positive impact of this efficiency on the climate would probably be nullified by Russian inefficiency and mounting emissions.

So, although there is no doubt that Russia will meet its obligations under the Kyoto protocol, the real question is whether Russia will also take pro-active measures to go beyond merely meeting its 1990 Kyoto target. The UN Framework Convention on Climate Change and the Kyoto protocol were meant as instruments to facilitate the collective efforts of the international community in cutting down emissions of greenhouse gases into the atmosphere. However, the Russian government is very much aware of the fact that many developing countries have no commitments under the Kyoto protocol, including such big emitters of greenhouse gases as China, India, South Korea, Mexico and South Africa. With the US also not having ratified, there are many doubts in Russia about the medium term viability of the Kyoto protocol. There is a substantial risk, therefore, that Russia and the international community will focus on the 'post-Kyoto' period for getting it right. In the meantime, the Kyoto protocol's implementation period has started this year, in 2008, and in Russia not the slightest attempt is made to reduce emissions. Unfortunately, the Russian government - among many other governments - still does not see that the Kyoto protocol is a no-lose proposition. Apart from political and economic considerations and the debate about the causes of global warming, reduction of greenhouse gas emissions and increasing energy efficiency is a winner in any case. No matter whether it is done locally or globally, voluntarily or obligatory, the winner is the planet. ■

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which is required for any JI project. Second, it gives the Russian government the right to disapprove any approved JI project at any time.

This means that in the short term the Kyoto Protocol and its flexible mechanisms are unable to contribute to energy efficiency enhancing investments in Russia. Once the required institutional infrastructure is in place to deal with emission reductions projects in the framework of the Kyoto Protocol a new assessment will have to be made of the possibility to finance or co-finance EE projects by means of JI or emissions trading.

#### Odd man out |

Why is Russia being so sluggish in implementing the procedures for JI projects, when they so obviously could benefit from them? One of the reasons can be found in Russia's motivation to ratify Kyoto in the first place. Russia's ratification was not so much the result of a concern for the environment but

worried that this would cause it to lose out to Russian rivals in many markets around the world. However, the EU wanted Russia in Kyoto badly enough to make a compromise and support its WTO membership bid. By doing so the EU accepted that Russia kept its domestic natural gas prices lower than the price on the international market as long as Russia agreed to slowly raise them. European companies also realized that having Russia sign on to Kyoto would help them because they could meet their own Kyoto targets more cheaply by buying Russian emissions reductions.

Secondly, Russia's approval of the Kyoto Protocol made the US the odd man out. The Bush Administration had been pressuring Russia not to ratify and Russia's ratification meant a major political defeat for President Bush. The third factor that played a role in the ratification by Russia was the Kremlin's desire to soften the criticism it received from the international community