King & Spalding

Client Alert

Energy

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EU Regulations Restricting Imports of Renewable Natural Gas and Green Hydrogen Derivative Products

1. INTRODUCTION

The European Commission (**EC**) is in the process of implementing its "Union database" (**UDB**) to track all renewable gases and liquid fuels. Gases and fuels, whether produced in the EU or imported, will need to be registered in the UDB if their use in the EU is to be counted towards satisfying the EU's mandated renewable energy quotas.

Since the need to satisfy these quotas drives a large part of the incremental value of these molecules compared to existing fossil fuel products, this change is relevant to all would-be suppliers of biomethane / renewable natural gas (**RNG**) to EU customers.

Other fossil fuel alternatives, such as green hydrogen and derivative products (**gH_2 Products**), will also need to comply with the requirements of the UDB if seeking to qualify for the EU quota markets.

Recently, the EC has proposed requirements for tracking imported RNG and gH_2 Products that would prevent all gases transported through gas grids outside of the European Economic Area (**EEA**)[1] from qualifying for the EU's renewable energy quota markets. These changes would take effect when the gas registry within the UDB is implemented, which is expected later in 2024.[2]

Effectively, this would mean that RNG and gH_2 Products transactions in the United States or another non-EEA country, if using the gas grid as the means of delivery, cannot be certified as complying with the EU's requirements, reducing their value for EU customers.[3]

This could significantly impact the commercial feasibility of projects under development.

Also, for existing supply agreements, contractual obligations contemplated at the time of executing those agreements could now be at risk. We are already seeing transactions being renegotiated, regulatory relief events being claimed, and contractual disputes beginning to arise.

2. KEY TAKEAWAYS

- Based on the current approach proposed by the EC, exports of RNG and gH_2 Products from the United States (or other non-EEA countries) that use the gas grid will not be counted towards the EU's renewables quota markets upon import in the EU.
- Producers of RNG and gH_2 Products and their customers in the United States (or other non-EEA countries) need to carefully assess the impact of these regulatory changes on their businesses. This includes identifying how risk and responsibility for certification, registration of RNG and gH_2 Product environmental attributes and changes in regulation are allocated in the project contracts. Although clearly in many cases commercially and technically infeasible, parties could consider whether alternative delivery methods (such as dedicated pipeline connections, trucks or railcars) or markets outside of the EU are possible.
- Outside of such self-help options, the EU has not proposed any pragmatic workaround solution for imports. It has only suggested that bilateral agreements would need to be agreed between the EU and exporting countries. Implementing such an approach could be time-consuming and both the process and its outcome would be outside the control, or ability to predict, of the private sector.
- This is yet another example of the increasing internationalization of EU energy and climate regulation. The extra-territorial effect of EU regulations in the energy sector is a trend that is expected to continue. This makes it important for producers of fuels and goods looking to access EU markets to consider applicable EU regulations early and on an ongoing basis.
- We are already seeing potential disputes and contractual renegotiations arising because of these issues. Industry participants should seek advice and take suitable preparatory steps accordingly.

3. THE PURPOSE OF THE UDB

The UDB is a centralized registry that must be used by all companies seeking to qualify renewable fuels for counting towards the EU's mandatory renewable energy quotas. This is important because these markets are often foundational to the business case of export projects, as they are supported by systems of credits and penalties to incentivize EU consumers to meet the quotas. Eligibility for these credits and the avoidance of penalties is a key driver of the value of renewable fuels, which influences their pricing and competitiveness in the market. The entire supply chain for these fuels (including imported fuels) must be registered in the UDB.

The UDB is intended to:

- increase transparency of claims that energy used in fuel production is sustainable and can therefore be counted as renewable for the EU's quotas;
- minimize the risk of double counting associated with such claims (e.g. claiming renewable status for the same fuels in multiple countries); and
- improve traceability and tradeability of renewable fuels amongst EU member states.

In addition to the UDB registration process, the EU has a system of certification that must be used by producers of RNG or gH_2 Products seeking to qualify for the EU quota markets. The certification process and the UDB are closely interconnected. The EU certification bodies (known as "voluntary schemes") and their scheme documents must be periodically approved by the EC.

To qualify for certification, and therefore to be eligible for counting towards the EU's renewable energy mandates, RNG and gH_2 Products must comply with the sustainability requirements of the EU's Renewable Energy Directive (**RED**).[4] Amongst other things, RED requires companies at every stage of the supply chain to trace RNG and gH_2 Products using a mass balance chain of custody system. The requirements for mass balance accounting are specified through several instruments of EU law and are implemented through the scheme documents for each EU-approved certification body. These certification bodies are responsible, through annual audits, for ensuring compliance by producers and other companies in the supply chain with the accounting principles of the RED-compliant mass balance system.

4. THE EU MASS BALANCE SYSTEM: WHAT HAS CHANGED?

This mass balance accounting system is designed to prevent double counting of renewable energy claims, while giving companies enough flexibility to operate their RNG or gH_2 Product production, transportation, and storage activities in a pragmatic way. This allows sustainability characteristics to remain assigned to defined quantities of product in the book-keeping, even while the physical quantities of a particular product are mixed with quantities from other (i.e., non-sustainable) sources.[5]

Under EU law,[6] the EU's interconnected gas grid is considered as a single mass balance system. This means that quantities of RNG or gH_2 Products injected at one point in the EU gas grid can be delivered at another point with the same sustainability characteristics. This can be achieved if the relevant environmental attribute certificates (namely, proofs of sustainability as well as any guarantees of origin, as they are known under RED) are transferred to the buyer taking delivery of the RNG or gH_2 Product and all parties in the supply chain are EU-certified and register these transactions in the UDB. Prior to the changes described below taking effect, this principle also continues to apply to gas grids outside the EU / EEA.

However, the EC has proposed (through directions given to the EU certification schemes and reflected in the revised scheme documents from January 2024) to deviate from the above approach in relation to foreign (i.e., non-EU / EEA) gas grids. In brief, the EC has proposed that there must be a system-wide mass balance for the entire interconnected gas grid in such countries (i.e., all claims of RNG / gH_2 Product injections into, and withdrawals from, that grid) that is covered by the UDB.[7] Only then can RNG or gH_2 Product that has been transported using the gas grid be certified for the purposes of RED and, therefore, be registered in the UDB for counting towards the EU's renewable energy quotas.

5. THE POLICY OBJECTIVE BEHIND THE RESTRICTION ON USE OF GAS GRIDS

The EC's purported policy objective is to prevent double counting of renewable energy claims in a country of production where RNG or gH_2 Products are imported into the EU for counting towards renewables mandates.

To achieve this, the EC is essentially requiring complete regulatory equivalence between the EU's accounting system for renewable energy and that of the foreign source of the relevant product. In fact, the EC has proposed that the entire system mass balance of a foreign country's gas grid needs to be covered by the UDB itself: i.e., the EC would seek to require the United States and other non-EEA countries to actually register all transactions on the gas grid in the UDB itself, the exact same registry system as the EU uses for tracing and counting renewable energy targets.

If the EC maintains this approach, then, in practice, some kind of recognition of parallel but equivalent systems is likely to be needed. The EC has suggested that it will negotiate bilateral agreements with exporting countries to create the necessary regulatory framework. This would be a novel process and achieving consensus on use of the UDB or parallel registries would be central to these agreements.

Clearly, though, this would be a highly bureaucratic way to approach the issue. The EU is prioritizing countries with physical interconnections (such as the U.K., Switzerland and Ukraine). So, it is not clear how long an agreement between the EU and the United States would take to reach. Add to this the fact that in 2024 the United States and the EU (amongst many other major economies) will hold elections, and it is apparent this could be a protracted process. In the meantime, once the gas registry of the UDB comes into effect, many RNG and gH_2 Product producers in the United States seeking to certify their products for EU renewables quota markets will be prevented from doing so, leading to a major negative impact on the market value of those products compared to fossil fuel alternatives. We are already seeing this value-depreciation taking place because of the uncertainty created in the market by this prospective change.

The risk for producers is obvious. There is also a risk for the EU itself, in that producers may look elsewhere for buyers, especially to Asia, where incentives for importing clean fuels are expected to proliferate during 2024.

6. AN ALTERNATIVE APPROACH TO PREVENT DOUBLE COUNTING

Why can the risk of double counting not be protected against by ensuring that EU-certified producers and buyers of RNG or gH_2 Products, if seeking to register the proof of sustainability in the UDB, ensure there is no further sale of environmental attributes outside the UDB, thus preventing the certificates from being double counted in the UDB and some other system?

In other words, rather than force an entire foreign grid to comply with EU rules for accounting renewable energy, **each entity in the supply chain** (whether connected to the gas grid or otherwise) could be required to ensure there is no other transfer of environmental attributes or guarantees of origin to any source outside of the UDB.

This is already how the EC has proposed to regulate against double counting of claims of renewable electricity which are used for production of renewable fuels of non-biological origin (RFNBO) outside the EU. In that case, the EC requires that any renewable energy certificates be registered and cancelled in the relevant local registry or equivalent. There is no suggestion that because foreign renewable electricity certificate registries may not be identical to the EU's that certifying bodies should deem such power to be non-renewable.

7. CONCLUDING REMARKS

A regulatory framework to prevent double counting of renewable energy claims should, and can, avoid over-complication. Rather than force all-or-nothing regulatory harmonization that requires political alignment at an international level, the same protection could be achieved unilaterally by regulating international private sector participants at the level of the supply chain. Since an RNG or gH_2 Product producer (and all stages of its supply chain) needs to be certified and audited by EU-approved certification bodies, the regulatory tools arguably already exist to protect against the risk of double counting.

With these protections in place, it does not seem plausible that the environmental attributes of RNG or gH_2 Products could routinely be claimed by third parties without the participation or consent of the producer (or other supply chain participant).

By contrast, regulating at the systemic level suggested by the EC risks unmanageable challenges for the private sector, with RNG export projects already operating between the United States (and other producer countries) and the EU, and many more, including projects to export gH_2 Products, in development. The EC's suggested approach risks limiting imports of valuable RNG and gH_2 Products that will play a crucial role in meeting the EU's energy security and decarbonization objectives.

8. INTRODUCTION TO KING & SPALDING ENERGY TEAM

King & Spalding's Global Energy Team comprises 300 lawyers who are fully integrated worldwide across 25 offices. It is actively advising clients on navigating these and other similar energy regulatory issues. Please get in touch if you would like to further discuss any part of this Client Alert.

[1] The EEA comprises the 27 member states of the European Union together with Iceland, Norway and Liechtenstein.
[2] There is a statutory deadline for this of November 21, 2024. The EC is targeting an earlier implementation date but significant administrative challenges remain before the gaseous value chain of the UDB can become operational.
[3] This is not the same as an outright ban on imports of RNG. Renewable gases can still be imported into the EU, but they cannot be counted as "renewable" for the purposes of meeting the EU's and EEA's mandatory renewable energy targets and quotas.
[4] Directive (EU) 2018/2001 of the European Parliament and of the Council of 11 December 2018 on the promotion of the use of energy from renewable sources (recast), as most recently amended in 2023.
[5] In practice, the details for a RED-compliant mass balance are more extensive and complex than this. This simply describes the principle that the mass balance system under RED aims to achieve. It is also important to note that a mass balance chain of custody approach differs from a book and claim system, which allows certificates to be traded separately from physical quantities of fuel. Maintaining a link between the renewable certificates and physical quantities of fuel that they represent is a core principle of the RED-compliant mass balance system.
[6] Commission Implementing Regulation (EU) 2022/996 of 14 June 2022 on rules to verify sustainability and greenhouse gas emissions saving criteria and low indirect land-use change-risk criteria.
[7] The relevant provisions added to, for example, the ISCC EU Traceability and Chain of Custody reads: "The mass balance of the interconnected infrastructure carrying the gas has to be in its entirety covered by the Union database." (para. 4.4.1).