SHEARMAN & STERLING LLP

Environmental Practice BRIEFING

SUMMER 2003

Following are recent developments in environmental law and policy that may be of interest to our colleagues, clients and friends:

European Union: Recent Developments

Emission Allowance Trading

In an effort to comply with its obligations to reduce greenhouse gas emissions under the Kyoto Protocol, on March 18, 2003, the Counsel of the European Union (the "CEU") approved a Directive establishing the regulation of European Union ("EU") greenhouse gas emissions based on a newly-created EU market for tradable emissions credits. On July 2, 2003, the European Parliament approved the plan. If passed by the Council of Ministers on behalf of the EU Member States, the regulations, together with the market for tradable emissions credits, will go into effect on January 1, 2005.

Initially, the Directive would cover only the emission of carbon dioxide ("CO_2"), a significant greenhouse gas, and apply only to specified industrial sectors that currently account for, in the aggregate, about 46% of EU CO_2 emissions (e.g., energy generating, ferrous metals mining and processing, mineral mining and processing, pulp, paper and board production).

Under the Directive, the government of each Member State would be required to design a national plan for making annual allotments of emissions credits to industrial facilities operating in that Member State. This allocation is intended to reflect the Member State's obligation under the Directive to reduce greenhouse gas emissions. While each operator of a covered facility may be required to purchase its annual allotment of emissions credits from the applicable Member State in the future, it is expected that the emissions credits would be free at least until the end of 2007. Covered industrial facilities generally would be prohibited from emitting CO_2 unless the facility operator holds sufficient emissions credits for the discharge of CO_2 emissions. Any operator that in the course of a year emits CO_2 in excess of the amount permitted by the emissions credits it holds would be subject to a fixed fine per metric ton of excess CO_2 so emitted. Operators whose facilities emit less CO_2 than the amount permitted by the emissions credits they hold, however, would be permitted to sell the "unused" emissions credits to any willing purchaser, including another operator. Conceptually, the market for the emissions credits—and in particular, any increases in value that accrue to the emissions credits—would reward operators who devise methods to emit less and less CO_2.

Disclosure of Environmental Information

On February 6, 2003, the CEU adopted a resolution supporting corporate social responsibility ("CSR"). The CEU's resolution furthers legislative efforts begun with the issuance on May 30, 2001, of a European Commission ("EC") Green Paper on promoting a European framework for CSR. CSR, as used in the recent resolution and the May 2001 Green Paper, refers to the voluntary integration of social and environmental concerns into a company's business operations. The resolution generally promotes increased public disclosure of relevant matters (in annual and other required reports), increased stakeholder involvement in decision making and incorporation of social objectives into corporate governance. The recent CEU resolution calls upon the EC to continue to promote the legislative efforts towards incorporating CSR principles into EU company operations and calls upon EU Member States to promote CSR at the national level.

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Tokyo
Toronto
Washington, D.C.

Control of Major Accidents Hazards Involving Dangerous Substances

In part due to recent major industrial accidents in Baia Mare, Romania (January 2000), Enschede, The Netherlands (May 2000) and Toulouse, France (September 2001), on September 9, 2003, a political agreement was reached between the CEU and the European Parliament on a proposed amendment to the December 9, 1996 Seveso II Directive on the control of major accidents involving dangerous substances. The Directive seeks to prevent major accidents on industrial sites and to limit the social and environmental consequences of such accidents. The Directive imposes safety and land use measures on industrial sites where designated hazardous materials are present. The proposed amendment will broaden the scope of the Directive to include more industrial sectors, such as certain mining activities, and will further restrict and regulate the use of hazardous materials, such as explosive and pyrotechnic material. The proposed amendment also provides for the inclusion of specified carcinogens on the list of hazardous materials and makes certain information about covered facilities more accessible to the public.

The proposed amendment of Article 12 of the Directive requires that new projects maintain appropriate distances between establishments covered by this Directive and residential and public use areas, buildings and major transportation facilities.

In a related development, on July 30, 2003, the French Parliament adopted Law No. 699-2003 regarding the prevention of technological and natural risks. This new law provides new land use planning tools for the control of urbanization around industrial plants at increased risk for major accidents.

United States: New Source Review Final Rule Issued

On August 27, 2003, the United States Environmental Protection Agency ("EPA") issued a final rule (the "Rule") that provides certainty regarding when routine equipment replacement activities require a detailed permit review pursuant to the New Source Review permitting program of the Clean Air Act ("NSR Program").

Congress established the NSR Program as part of the 1977 Clean Air Act Amendments to help control emissions from major new stationary sources of air pollution such as power plants, refineries, pulp and paper mills, chemical plants and other significant industrial facilities. The NSR Program was designed to ensure that state of the art control technology was installed in new facilities or at existing facilities undergoing a "major modification". Exemptions from NSR Program requirements are permitted for "routine maintenance, repair and replacement" projects. As the cost of designing, purchasing and installing such control technology can be substantial, the application of these exemptions has been disputed (and litigated) since the NSR Program's inception.

The Rule clarifies the meaning of "major modification" and "routine maintenance, repair and replacement", and provides helpful definitions for other essential terms of the NSR Program process. Specifically, the Rule creates a category of activities that will automatically be considered "routine maintenance, repair and replacement" for NSR Program purposes. Under the Rule, equipment replacement activities will be excluded from the NSR Program if: (a) the activities involve the replacement of any existing component(s) of a process unit with an identical or functionally equivalent component(s); (b) the fixed capital costs of the replaced component do not exceed 20% of the replacement value of the entire process unit;* (c) the replacement does not change the basic design parameters of the process unit; and (d) the replacement does not cause the unit to exceed emission limits.

Promulgation of the Rule raises questions about pending Justice Department enforcement actions (commenced on November 3, 1999) against numerous electric utility com panies regarding multiple power plants. These suits allege that the utilities made major modifications to their facilities that were not exempted from NSR Program coverage due to being acceptable routine maintenance or repair. All of the suits relate to "grandfathered" power plants (those that existed at the time the Clean Air Act was amended in 1977) that were not required to retrofit existing units with new air pollution controls unless the utilities undertook "major modifications" of those plants. Under the Rule, similar activities at many of these facilities would not trigger the NSR Program and would not constitute violations of the Clean Air Act.

Claiming that the Rule would permit thousands of industrial facilities to make extensive upgrades without installing anti-pollution equipment required by the Clean Air Act and therefore would lead to increased pollution in their states, the attorneys general of New York, Connecticut, Massachusetts, California and other states have promised to file lawsuits to block the implementation of the Rule.

*Under the Rule the replacement value of the entire process unit may be determined in accordance with any of the following methodologies: (1) replacement cost; (2) invested cost, adjusted for inflation; (3) the insurance value, where the insurance value covers the complete replacement of the covered unit; or (4) another accounting procedure to establish a replacement value of the process unit if based on Generally Accepted Accounting Principles.

International: The Equator Principles

In June 2003, 10 banks based in seven countries announced their adoption of the Equator Principles. The Equator Principles are a voluntary set of guidelines for the consideration of social and environmental responsibility in connection with the financing of development projects valued at $50 million or more.

The banks have committed to applying the Equator Principles around the world in all sectors, including mining, oil and gas, and forestry. The banks that have adopted the Equator Principles pledge to provide loans only to projects whose sponsors can demonstrate the ability and willingness to ensure that the projects are developed in a socially responsible manner and in accordance with sound environmental management procedures. Specifically, in addition to other obligations, the Equator Principles require signatory banks to categorize all potential projects as A (high), B (medium), or C (low) in environmental or social risk as a precondition to consideration for financing.

As part of the underwriting process, borrowers must conduct an environmental assessment and prepare an environmental management plan for category A and B projects. The banks that have adopted the Equator Principles are:

- ABN AMRO Bank, N.V.
- Barclays plc
- Citigroup, Inc.
- Credit Lyonnais
- Credit Suisse Group
- HVB Group
- Rabobank Group
- The Royal Bank of Scotland
- WestLB AG
- Westpac Banking Corp.

The Equator Principles are based on the policies and guidelines of the International Finance Corporation ("IFC"), the private-sector investment arm of the World Bank. IFC provided extensive advice and guidance regarding the drafting of the Equator Principles.

United States: Guidance on Federal Recognition of State Voluntary Cleanup Programs

In March 2003, the EPA issued a statement (the "Statement") clarifying the circumstances in which it would indefinitely defer enforcement or cost recovery actions under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA") when environmental contamination was investigated and remediated in accordance with a state voluntary cleanup program (a "VCP").

In an effort to facilitate remediation of contaminated sites, most states in the United States have enacted VCPs over the past 10 years. These programs generally promote cleanups led by responsible parties or others who are rewarded for a satisfactory remediation project with the state's promise (often called a "Covenant Not to Sue" or "CNS") not to seek further cleanup or otherwise hold the "volunteers" responsible for the costs of additional remediation of the contamination in question. However, a CNS does not provide protection against potential federal response actions under federal environmental law. In January 2002, CERCLA was amended to give comfort to potential VCP volunteers that their VCP efforts generally would satisfy both state and federal authorities.

As amended in 2002, CERCLA § 128(b) provides that except in specified circumstances, a governmental enforcement or cost recovery action may not be initiated under CERCLA when the contamination of concern at an "eligible response site" has been or is being addressed in compliance with a state VCP that is adequately protective of public health and the environment. Among other things, an adequate VCP must:(a) be subject to sufficient oversight and enforcement authority to ensure that cleanup actions performed are effective and will be completed if the property owner fails to complete them; (b) provide for public participation in the selection of cleanup plans; (c) have appropriate mechanisms for the review and approval of cleanup plans; and (d) require that either state officials or an authorized, licensed professional verify that an environmental cleanup has been properly completed at a site.

According to CERCLA § 101(41), the following are "eligible response sites":

1. Brownfield Sites: These are sites "complicated by the presence or potential presence of a hazardous substance, pollutant or contaminant."

2. LUST Sites: These are sites for which financial assistance has been obtained under the federal Leaking Underground Storage Tank Trust Fund for remediation activities.

3. Other Sites: These are sites where the government has determined both that a cleanup must be conducted in order to "protect human health and the environment" or "promote economic development or create recreational or undeveloped property" and that the limitation on federal government action set forth in CERCLA § 128(b) would be appropriate.

Expressly excluded from the definition of "eligible response sites" are: (i) sites listed on the National Priorities List (the "NPL") of highly contaminated sites; (ii) sites subject to enforcement actions under various specified federal environmental laws; (iii) sites where there has been a release of PCBs; (iv) sites of particular environmental concern; and (v) sites that are qualified to be on the NPL and for which EPA has not ruled out future federal action.

The Statement provides guidance to government officials regarding the last of these exclusions (i.e., clause (v) above)): the determination of sites to be excluded from the definition of "eligible response site" due to their qualification for inclusion on the NPL. In accordance with the Statement, the determination that a site is not an "eligible response site" due to being qualified for listing on the NPL is a two-step process. The EPA must first determine whether a particular site qualifies for inclusion on the NPL. A site may be determined to be qualified for inclusion on the NPL if the site earns a score of at least 28.5 on EPA's Hazard Ranking System ("HRS"). In accordance with the Statement, the EPA should only determine that a HRS score of 28.5 has been earned when it can do so with a high degree of certainty (e.g., after appropriate investigation has occurred in accordance with proper protocols). In addition to having earned a HRS score of at least 28.5, a site may be deemed not to be an "eligible response site" due to being qualified for inclusion on the NPL if: (A) the applicable state has designated that the environmental conditions at the site are of the highest priority for response; or (B) the federal government has determined that the environmental conditions at the site are a significant threat to public health and the EPA has initiated a remedial action in response to that threat.

After the EPA has determined that the site qualifies for inclusion on the NPL, the EPA must expressly classify the site as not being an "eligible response site". The Statement emphasizes that the EPA should rapidly review NPL qualification determinations so that potential VCP volunteers will know whether a particular site is an "eligible response site" and is therefore subject to the protections of CERCLA § 128(b). The Statement also emphasizes that with respect to the numerous sites that already are qualified to be listed on the NPL (due especially to previously-calculated HRS scores), the determination that such sites are not "eligible response sites" should be made en masse (if appropriate) and as soon as possible. The Statement indicates that even if a site is determined not to be an "eligible response site" it may become an "eligible response site" if the EPA later determines that "no further federal action will be taken" in respect to that site.