

Russian Federation: Sakhalin — A front-runner of Russian climate policy

In brief

In July 2021, Russia adopted its first ever law on reducing greenhouse gas (GHG) emissions ("**Core GHG Law**").¹ The Core GHG Law establishes the framework for federal-wide mandatory carbon reporting and voluntary climate projects. It does not set a price on carbon — either as a carbon tax² or as an emission trading system (ETS).³

In depth

Taken broadly, in addition to the Core GHG Law, the Russian climate package will include the following:

1. **Regional carbon pilot schemes** — to test heavier GHG regulation for a given region without burdening the rest of Russia (Sakhalin will pioneer such experiment with its local ETS, and Kaliningrad oblast, Khanty-Mansi autonomous district, Altay krai, Bashkiria republic and some other Russian regions may follow)⁴
2. **Low-carbon development strategy until 2050** — to define Russia's strategic vision of possible paths and targets of decoupling economic growth from GHG emissions with some prospects of carbon neutrality
3. **National green and transitional projects taxonomy** — to mobilize finance into projects with positive climate and environmental impacts, with potential incentives for both lenders and borrowers
4. **Carbon polygons and farms experiment** — to ensure scientifically validated stock taking of Russian forests and other plants, soil, swamps and other natural systems' absorbing capacity (in case of polygons) and running carbon sequestration projects (in case of farms)

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¹ See Baker McKenzie, [Russia: Government adopts its first ever greenhouse gas law - The core of its national climate package](#).

² Per today, there are 35 carbon pricing initiatives on a national or a subnational level. Examples of national systems are Canada, Mexico, Argentina, Colombia, South Africa, Japan and several European countries. Subnational examples are Catalonia, several US states and several Canadian provinces. See World Bank, [Carbon Pricing Dashboard](#).

³ Per today, 38 jurisdictions have or are about to set up their ETS or so-called cap and trade systems on regional (EU ETS), national (China, Indonesia, Turkey and Chile) and subnational levels (several US states, and several Canadian and Chinese provinces). See World Bank, [Carbon Pricing Dashboard](#).

ETS implies that its regulator sets upper limits for GHG emissions (caps) for companies participating in the ETS. Companies that exceed their caps in a given year have to purchase the emissions allowances (right to emit) from companies that manage to decrease their emissions lower than their caps. Companies that fail to comply with their caps or that fail to purchase the required number of emissions allowances must pay a fine, which is usually much higher than the costs of buying the allowances.

⁴ According to media reports. No information about legislative initiatives in those regions is available yet.



5. **Related cleantech policies** — to ramp up the development of new industries and to modernize the existing ones while reducing GHG, for instance, Russia recently extended its renewables program until 2035,⁵ announced its plans in the hydrogen⁶ and electric vehicles industries,⁷ and it plans to increase the ambitions of its energy efficiency improvement plan and to tighten its waste management system⁸

Why is Sakhalin so special?

The Sakhalin region is located on an island in Russia's Far East, north of Japan. It is geographically isolated from continental Russia and, therefore, it has unique geographical and climate settings.

It is also a home for several landmark oil and gas (including liquefied natural gas (LNG)) projects run by joint ventures of Russian and global energy giants, many of which are now pursuing ambitious decarbonization plans. For that and other reasons, Russia is beginning to see Sakhalin as a hub for blue and green hydrogen exports to Asia Pacific.

Some say that Sakhalin has a great potential in renewables — primarily wind and geothermal — to develop electric and gas-powered vehicles, to switch its diesel power generation to LNG and to increase GHG absorptions.

With the above in mind, the Sakhalin authorities plan to reach net-zero emissions by 2025.

Experiment timeline

In December 2020, the government approved the roadmap ("**Roadmap**") for the trial regulation in Sakhalin to: (i) establish a framework to implement GHG reduction technologies; and (ii) test methodologies to record and verify GHG emissions and absorptions.

In particular, the Roadmap provides that the regional ETS should be set up by February 2022 and be integrated with international systems by July 2022. The priority climate projects are planned for implementation between September 2021 and February 2023 - with the first outcomes of such projects to be entered into the carbon registry by July 2022. The first transfer of emissions reduction units (offsets) should take place by July 2022.

In April 2021, the Russian Ministry of Economic Development submitted a draft law on the special regulation of GHG emissions and absorptions in Sakhalin ("**Sakhalin GHG Bill**").⁹ If adopted, the Sakhalin GHG Bill will become law effective 1 January 2022. The experiment will run from that date until 31 December 2025.

Effective 1 January 2023 the Sakhalin GHG Bill will apply to companies CO₂ emissions no less than 50,000 tons in 2022 and 2023. Such entities will be viewed as 'regulated entities'. Effective 1 January 2025 the Sakhalin GHG Bill will apply to companies with CO₂ emissions no less than 20,000 tons in 2024 and onward.

What does the Sakhalin GHG Bill specifically provide?

The objective of the experiment is for Sakhalin to reach carbon neutrality — a scenario when annual GHG emissions equal their annual absorptions. The key tools to achieve this objective include the following:

1. **GHG cadastre:** The Sakhalin authorities will develop the cadastre following assessment of the local GHG emissions and absorptions. They will do so in accordance with the standards of the Federal Ministry of Natural Resources and Environment and confirm the results with the Federal Service for Hydrometeorology and Environmental Monitoring.

⁵ See Baker McKenzie, [Russia to kick-off second round of its renewables program in September 2021](#).

⁶ See Baker McKenzie, [Russia Taking a Stand in Global Hydrogen Race](#). The targets for hydrogen exports have grown following the date of the publication.

⁷ See Baker McKenzie, [Russia: Jump-start of a national electric vehicles industry](#).

⁸ For further details on Russia's climate, cleantech and environmental protection policy, see Section 25 of Baker McKenzie's [Doing Business in Russia](#) guide.

⁹ This publication is based on the version of the Sakhalin GHG Bill of 15 September 2021, available at [Regulation.gov](#), which is the official resource for draft laws and regulations.



2. **Experiment program:** The Sakhalin government will develop such a program by coordinating with the federal authorities. It should also discuss the program with regulated entities. The program will define the set actions needed to achieve carbon neutrality and the respective timeline. The authorities will monitor the implementation of the program based on the annual carbon reports of regulated entities.
3. **Mandatory carbon reporting:** Regulated entities will have to report on their emissions in accordance with the Core GHG Law, subject to lower (more stringent) emissions criteria.¹⁰ The reports will have to be verified in accordance with international standards by expert organizations certified by VEB.RF, the Russian development institution responsible for sustainable finance, among other things.
4. **Cap and trade system:** The authorities will set the caps annually based on the verified carbon reports of regulated entities in accordance with a federally approved methodology. The authorities should also oversee the discussions on the program with regulated entities, as well as the pace of the progress toward carbon neutrality.

To comply with the caps, regulated entities may purchase and retire¹¹ the emissions allowances, as well as the carbon offsets. Regulated entities that fail to meet their caps will pay a charge equal to: (i) the amount of CO₂ equivalent in excess of the cap; multiplied by (ii) the ratio to be defined by the federal government. Failure to pay the charge will trigger an additional penalty payable per day of delay.
5. **Climate projects:** Regulated entities and possibly other companies will be able to implement projects that result in GHG emissions prevention, reduction and absorption in line with the Core GHG Law. Following such projects, they will be able to sell the carbon offsets (verified outcomes of climate projects). Regulated entities may be able to comply with their emissions caps by retiring their carbon offsets registered in a separate Sakhalin-devoted section of the carbon registry under the Core GHG Law.
6. **Economic incentives for GHG reductions and implementing the best available technologies:**¹² Such incentives may include regional tax, subsidies and other benefits.

Several Russian banks and commodity exchanges are discussing possibly setting up organized auction trades of the allowances and offsets under the Sakhalin GHG Law, as well as the offsets under the Core GHG Law.

Will the Sakhalin ETS protect Russian companies from the European Union (EU) 'carbon tax'?

As part of the EU Green Deal, the EU has set a binding target for itself to achieve a 55% GHG emissions reduction by 2030 and carbon neutrality by 2050. This implies the substantial tightening of the EU ETS for its participants by: (i) expanding the ETS to new sectors that were previously uncovered, such as shipping, road transport and buildings; and (ii) reducing the free quotas (caps) for industries like steel, cement, plastic, paper, glass, fertilizers and sugar.

The ETS reform presents risks of "carbon leakage," meaning that carbon-intensive companies may migrate their production outside of the EU and then import back. To prevent such risk, as well as to generally equalize the ETS participants and third countries' importers, the EU is developing a carbon border adjustment mechanism (CBAM).

The CBAM implies that the importers will have to purchase CBAM certificates in the amount corresponding to the "embedded emissions" of their products. The price of the CBAM certificates will be linked to the prices of the emissions allowances under the EU ETS.

The CBAM design to date provides that the importers may be able to decrease the amount of the needed CBAM certificates if they have made a payment for GHG emissions that is mandatory in their home country. This means that the EU regulators will most

¹⁰ Companies must commence reporting on 1 January 2023 if their annual GHG emissions exceed 150,000 tons and if they meet the criteria of "regulated entities"; for companies with emissions in excess of 50,000 tons, the date is 1 January 2025. The Russian government is to define the criteria for regulated entities and reporting forms.

¹¹ Exercise of the right to utilize the allowance or the offset against the cap. This implies transferring the allowance or offsets to a specific "retirement account" in the carbon registry, following which the allowance or offset can no longer be sold.

¹² It is unclear whether the best available technologies under the Sakhalin GHG Bill have the same meaning as in general Russian environmental law.



likely not recognize purchasing carbon offsets on a voluntary basis (under the Core GHG Law or otherwise) as a valid tool to reduce CBAM payments. Similarly, purchasing renewable energy certificates is also unlikely to be exempt from the CBAM.

The Sakhalin GHG Bill and potentially other Russian regional ETSs aim to introduce a mandatory carbon payment for regulated entities. Conceptually, if such entities export their products to the EU, they may try to reduce the amount of CBAM certificates. However, the legitimacy of such a reduction will have to be additionally verified depending on the evolving CBAM design, the recognition of relevant methodologies chosen by the Russian regulators and other intricacies.

In addition, CBAM reduction may only be effective if the prices of emissions allowance under the Sakhalin ETS (or another regional ETS) is comparable with those under the EU ETS. Otherwise, a Russian regulated entity importing products to the EU will still have to purchase the CBAM certificates to "catch up" with the EU ETS participants in terms of the price they pay for the allowances.

Climate policy objectives beyond the CBAM

The CBAM is just one of a few incentives for Russian companies to decarbonize and participate in carbon trades in Sakhalin and the rest of Russia.

Other important incentives include the following:

1. **Divestment:** Numerous pensions funds, sovereign wealth funds and asset managers continue to withdraw their funds from carbon-intensive industries and to redirect them into more sustainable ones. This is especially relevant for Russian entities with foreign equity investors and/or that are listed on global stock exchanges. Climate-responsible companies may secure existing and attract new equity investors with "green investment mandates."
2. **Access to debt finance:** A number of major global banks are starting to refuse to finance carbon-intensive projects. Simultaneously, they are developing new preferential types of green and sustainability-linked finance, making borrowings cheaper. Similar trends are taking place in insurance and some types of professional services.
3. **Supply chains:** Numerous automakers, tech companies, equipment producers and many other companies are voluntarily moving toward carbon neutrality for their whole supply chain. At the same time, companies that produce commodities and products with a lower carbon footprint gain competitive advantages.
4. **General business efficiency considerations:** GHG emissions reductions under the ETS or voluntary climate projects may trigger industrials and other companies to mobilize investments into technological upgrades that have positive economic effects, for instance, linked to fuel or other resource efficiency.¹³

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¹³ Subject to compliance with basic principles of climate projects, such as additionality, which requires the company implementing the project to justify that the project would not have taken place due to economic unfeasibility, if the company were not able to sell the carbon offsets following the project's implementation.



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