



USE OF CDM/JI PROJECT CREDITS BY PARTICIPANTS IN PHASE II OF THE EU EMISSIONS TRADING SCHEME – A WWF SUMMARY OF THE ECOFYS UK REPORT, NOVEMBER 2006

Introduction

The EU Emissions Trading Scheme (EU ETS) is a crucial cornerstone of climate change policy in the UK and Europe and will play a key role in the establishment of a global scheme. Indeed, in his response to the release of the Stern Review, the Chancellor Gordon Brown laid out the Government's vision for how the ETS should develop if it is to lay the foundation for a global carbon market which would deliver significant emissions reductions and lead to a low carbon global economy¹.

Phase II of the EU ETS (2008-2012) will therefore be a real test as to whether market based mechanisms can deliver significant emissions reductions in the EU. WWF is extremely concerned that the allocation plans proposed by many Member States will, if approved in their current form, seriously undermine the ETS at this critical stage.

Many Member States have proposed lax caps, while the uptake of auctioning as a way to allocate allowances has been disappointingly low. Moreover, many Member States have also proposed limits on the use of imported project credits² which are far in excess of the level of effort for phase II. Importing credits from Clean Development Mechanism (CDM) and Joint Implementation (JI) projects could make it cheaper for EU industry to reduce emissions.

Access to significant volumes of cheap credits from overseas could disincentivise investment in clean technology development in the EU and slow down innovation. It also raises concerns regarding the polluting nations of the north transferring responsibility for tackling climate change to the developing world - and is in clear breach of both the Linking and the ETS Directives. These require that any use of project credits must be supplemental to domestic action e.g. that a significant proportion of the effort required to reduce emissions, which could be taken to mean 50% or more, should take place at home³.

WWF commissioned Ecofys UK to look at this issue in more detail and to assess the impact it could potentially have on the scheme during phase II. The analysis focussed on the following Member States National Allocation Plans (NAPs) which account for roughly 80% of emissions in the EU ETS:

- Germany, UK, Poland, Ireland (notified to the European Commission); and
- France, Spain, Italy, Portugal and the Netherlands (draft NAPs available at time of assessment).

The findings of this study, as interpreted by WWF, are given overleaf.

¹ http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/chancellorsexchequer/speech_chx_301006.cfm, 30 October 2006

² The Kyoto protocol established Joint Implementation and the Clean Development Mechanism in order to help countries with emissions reductions targets to reduce the cost of meeting their targets by investing in projects abroad which cost less than they would at home. In addition - one of the key aims of the Clean Development Mechanism is to help developing countries achieve sustainable development.

³ The ETS directive states "In accordance with the relevant provisions of the Kyoto Protocol and Marrakesh accords, the use of the mechanisms should be supplemental to domestic action and domestic action will thus constitute a significant element of the effort made."

The analysis shows:

- **Current caps suggest minimal level of effort beyond Business as Usual (BAU) for a number of countries.** Based on the proposed caps the estimated total annual net shortage of allowances in the EU countries analysed is **between 8 and 118 million tonnes of carbon dioxide (MtCO₂) per year**. The higher figure was calculated by assessing the difference between the proposed caps and Member States' official BAU emissions projections⁴. However, 2005 verified emissions data for the ETS sectors, which showed that a large over allocation had taken place, indicates that official BAU projections are frequently inflated. To take account of this Ecofys also assessed the difference between the proposed caps and an estimate of BAU based on PRIMES projections (which gave the lower figure)⁵. The lower figure (8 MtCO₂) equates to a proposed cap which is only 0.5% below the PRIMES-based business as usual emissions projections.

Ecofys also assessed what the gross shortage of allowances might be, which would be important to consider if a significant price differential exists during phase II of the scheme between EU allowances and JI/CDM credits (which are currently cheaper). If JI/CDM credits remain cheaper than EU allowances, this could mean that companies which are short of allowances might choose to buy JI/CDM before they would buy EU allowances from companies which were long, potentially bringing relatively more JI/CDM credits into the scheme. The gross shortage was assessed to be between 118 and 123 MtCO₂ per year.

- **Allowed use of JI/CDM credits is significantly larger than the expected shortage so all abatement could potentially take place outside the EU** – The findings showed that for the countries analysed there was a theoretical maximum of at least **280 MtCO₂ equivalent per year** of CDM/JI credits that installations would be allowed to use in phase II, creating no effective restriction when compared to the estimated shortage. Whilst it is acknowledged that this is a theoretical maximum and that all installations in all countries may not use their maximum number of credits it must be recognised that the setting of restrictions in only some Member States will not result in a cap on the inflow of JI/CDM credits into the EU ETS. In summary, therefore, the scheme will only ever be as strong as its weakest link.

⁴ Note that for Germany it was not possible to take official BAU projections from the National Allocation Plan (NAP). The "official" BAU figure was therefore calculated separately using national CO₂ projections for 2010 from the fourth National Communication and the projected share of national CO₂ emissions that the EU ETS sector accounts for from the NAP.

⁵ PRIMES is a "market equilibrium" model for energy supply and demand in the EU(30) often used in policy development and evaluation by the European Commission. It is based on energy data for all Member States and Member States have the chance to comment on data and assumptions.

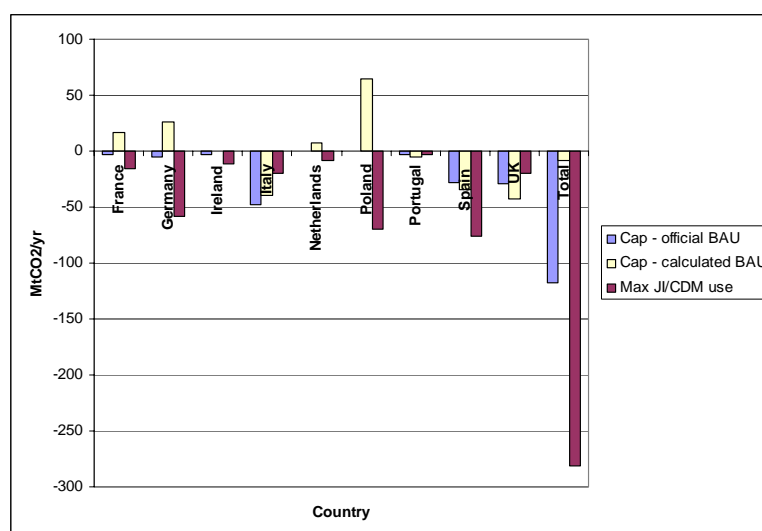


Figure 1 Proposed Phase II cap minus official and calculated (from PRIMES data) ETS sector BAU figures and theoretical maximum JI/CDM credit use⁶.

- Expected global supply of JI/CDM is unlikely to be the limiting factor to use of JI/CDM credits by EU ETS participants in phase II once the potential use by governments to meet their Kyoto targets is taken into account.** Supply of credits is estimated to be around 400 MtCO₂eq per year during 2008-2012 - with a possible range of between **200 and 600 MtCO₂eq per year**. A conservative global demand from governments is estimated at 130 MtCO₂eq per year⁷.
- Initial estimates show that up to one third of the project credits available during 2008-2012 will be from non-CO₂ gas abatement projects.** One of the key aims of the CDM is to help developing countries achieve sustainable development. WWF considers that industrial gas abatement projects have little or no wider sustainable development benefits and do not help catalyse the transition to non-fossil fuel based energy systems in project host countries, nor do they encourage greater energy efficiency.
- Sufficient low cost emission reductions seem to be available within the EU ETS sectors to meet all or most of the expected net shortage.** It is estimated that around 110MtCO₂ per year technical emissions reduction potential exists within manufacturing industries covered by the EU ETS. Previous experience and existing studies suggest that in the timeframe available in the second phase of the EU ETS around **35Mt abatement would be achievable at zero or low cost per tonne of carbon saved**. This is in excess of the lower end of the range for the estimated net shortage across the 9 NAPs analysed (8 MtCO₂ per year) and further highlights the fact that collectively, required efforts are limited. In reality whether internal abatement will take place will depend on a number of factors e.g. the carbon price; barriers to internal emission reductions such as lack of information, low priority and management attention, limited access to capital, high (perceived) risks; familiarity with trading and the internal carbon market.

Conclusions:

In summary we can conclude that collectively across Europe (for the NAPs analysed) the cap for phase II could be very weak and hence the gap (assessed here to be between 8 and 118 MtCO₂ per year for the

⁶ Note that the proposed phase II caps minus official BAU emissions projections for both Netherlands and Poland is close to zero.

⁷ This estimate currently excludes Canada as it is not clear whether they intend to comply with their Kyoto target or not.

countries analysed) could be small. Indeed the proposed use of project credits could fill this gap several times over so that potentially zero abatement could take place within the EU. In addition up to a third of these credits may offer little or no sustainable development benefits to the host countries.

There is nevertheless, scope (particularly taking into account the potential for low cost internal emissions abatement at zero or very low cost) for the cap to be significantly tighter. However, without a much stricter limit in place on the use of project credits this could still potentially result in the vast majority of abatement taking place outside the EU.

WWF RECOMMENDATIONS

This analysis raises key concerns over whether the EU ETS will deliver its true potential and lead to significant emissions reductions within the EU. Much will depend on the decisions that the European Commission makes over the coming few weeks and we, WWF, would urge them to take into account the following key recommendations:

- The collective cap for phase II should be made significantly tighter than phase I.
- In line with the “supplemental” wording in the ETS Directive, the limit on the maximum use of project credits should be set at a level considerably lower than 50% of the total effort. This would ensure that a significant proportion of emissions reductions would take place within the EU. Even though some countries have placed limits on the use of CDM/JI credits which are potentially below the level of effort, unless restrictions are applied across all Member States excess credits could continue to enter the scheme via the countries with no quantitative limits. Also, if this recommendation were adopted alongside a more robust cap there would be a larger gap (or greater potential net shortage) and this could actually lead to a greater investment in JI/CDM projects in terms of volume than if unrestricted access were given in a system which had a weak cap.
- The limit on the use of project credits should be set at the installation level and on an annual basis.
- For future phases beyond 2012, we recommend that the principle of supplementarity should be retained in full and made operational by clear rules and a harmonised approach across the EU. We are aware that some industry bodies are calling for unrestricted access to project credits in future – this would be a huge mistake, as it would fail to put Europe on a low-carbon trajectory and allow heavy industry and electricity generators to simply buy their way out of the problem.
- Beyond 2012, to ensure that projects really benefit sustainable development in the host country we would recommend that further qualitative criteria are imposed on the use of project credits e.g. use of Gold Standard⁸ certified projects should be considered. The Gold Standard is an internationally recognised benchmark which sets important sustainable development criteria for emission reduction projects - criteria which are currently lacking from the CDM Executive Board standards.

In summary – unless the European Commission acts to require robust caps and uniform restrictions on the use of project credits across all Member States there are grounds for serious concern that the ETS will fail to deliver significant reductions in greenhouse gas emissions within the EU. This has profound implications for the future of the scheme and the review of the Directive which is about to commence.

⁸ see <http://www.cdmgoldstandard.org>