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Carbon Market Watch

THE ELEPHANT IN THE ROOM:

# INTERNATIONAL OFFSETS IN EU'S 2020 CLIMATE LEGISLATION

**Policy Brief October 2013**

# EXECUTIVE SUMMARY

The use of international offset credits was originally meant to be a cost containment tool. However, due to the economic crisis, EU emissions have been substantially lower than expected. This rendered the quantity limit of international credits for the period 2008 to 2020 too generous. According to the recent European Commission report "The state of the European carbon market"[1], the use of international offsets in Europe's Emissions Trading Scheme (EU-ETS) has almost doubled the oversupply in the period 2008-2011 and will amount to three quarters of the oversupply by 2020. A new report "Trend and projections in Europe 2013"[2] published in October 2013 by the European Environmental Agency (EEA) shows that EU Member States will over-achieve the EU's 20% greenhouse gas reduction target for 2020 without implementing any new policies and measures.

In addition, numerous reports have presented evidence that the Kyoto's offsetting mechanisms may have delivered much fewer emissions reductions than were sold. One study estimates that up to 70% of all offset credits issued from the Clean Development Mechanism (CDM) between 2013 and 2020 may not represent real emissions reductions. The environmental integrity of the other Kyoto offsetting mechanism Joint Implementation (JI) is even more questionable with over 90% of offsets issued by Russia and Ukraine with very limited transparency and no international oversight.

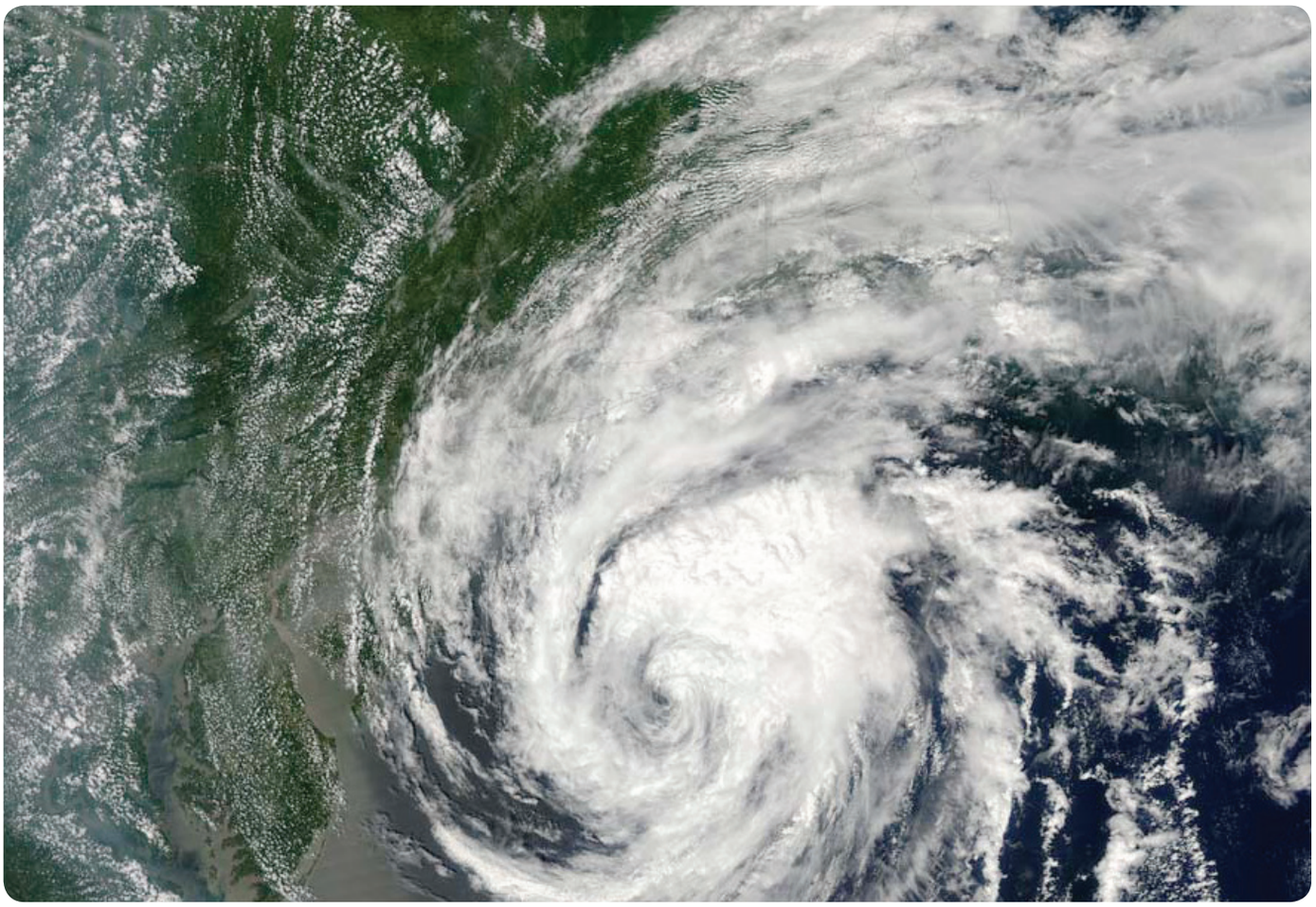
EU Member States took a first step to address these quality concerns by banning offset credits from industrial gas projects. However, this ban has not yet been fully extended to the non-ETS sectors governed under the Effort Sharing Decision (ESD). Moreover, recent studies show the lack of environmental quality of other project types, notably large-scale energy projects and projects under Joint Implementation track 1. These have not been addressed so far, neither at the UNFCCC nor the EU level.

Putting in place further use restrictions is a vital step to avoid that EU climate legislation is undermined by substandard carbon credits that increase global emissions if used to meet the EU climate target.

**Carbon Market Watch recommends that offset credits from following project types be banned for use in both, the EU-ETS and the ESD for the period from 2013 – 2020:**

- **Industrial gas projects that destroy HFC-23 and N2O from adipic acid production**
- **Large-scale power projects, including hydropower, wind power, natural gas, and coal power**
- **JI track 1 projects**

**Moreover, a do-not harm assessment should be introduced that suspends offsetting projects in case of evidence of human rights abuses.**



## THE STATE OF INTERNATIONAL CARBON MARKETS

In 2012, the markets for both Kyoto offsetting mechanisms – the Clean Development Mechanism (CDM) and Joint Implementation (JI) – have collapsed and prices, currently at below Euro 0.4, may not recover any time soon. The reason for this price crash is two-fold: first, low demand due to the economic downturn and weak emission reduction targets; and second, a significant over-supply of carbon offsets in large part due to lenient rules.

Prices for allowances from Europe's Emissions Trading System (EU-ETS) have dropped considerably because of a large oversupply of almost 2 billion EU allowances. Yet, only insufficient policy reforms have been passed to address the oversupply.

While established carbon markets are faltering, policy makers all around the world are planning to implement new market schemes, such as offsetting programmes and cap-and-trade schemes. China, California, Korea, Chile, Quebec, Japan are just a few of the regions and countries that are planning their own carbon offset or cap-and-trade schemes outside the Kyoto Protocol. The World Bank's Partnership for Market Readiness (PMR) is fostering the development of such new market schemes.

Under the UNFCCC's Framework for Various Approaches (FVA) and the New Market Mechanism (NMM) countries are negotiating if and how such new carbon markets should be governed internationally and how traded units should be accounted for so that their units can be used to meet mitigation commitments made under both the Kyoto Protocol and the UNFCCC. The EU is a strong proponent of developing these new markets schemes.

Parties are also currently negotiating a new climate deal. Under the Ad Hoc Working Group on the Durban Platform for Enhanced Action (ADP) Parties aim to develop a new more comprehensive climate agreement by 2015 for the period starting in 2020. It is still unclear what the role of carbon markets in general and international offsets in particular will be under a future treaty.

# THE TROUBLE WITH OFFSETS

Offsetting mechanisms aim to reduce the overall costs of greenhouse gas abatement, by allowing flexibility in the location and sector of emission reductions. Offsets are a zero-sum game for the atmosphere. For every offset purchased, the buyer can increase its emissions by an equivalent amount above its reduction target. This results in the same total emissions as would occur in the absence of offsets. In other words, offsetting does not lead to emission reductions per se, it only allows for the geographical or sectoral shift of the emission reductions.

This means that global emissions actually increase, when offsets do not represent emissions reductions that are in addition to what would have happened anyway. Current rules for additionality (see box) allow for business-as-usual projects to qualify for the CDM and JI and hence have resulted in the issuance of millions of credits that do not represent any additional emission reductions.

Research[3] recently released under the CDM Policy Dialogue estimates that the CDM may have delivered less than 40% of the emissions reductions it sold. If non-additional projects remain eligible in the CDM and the resulting credits are used for compliance, they could increase cumulative global GHG emissions by up to 3.6 Giga tonnes CO2e through 2020.

## ADDITIONALITY

Additionality, the concept that only projects that are beyond business-as-usual receive offset credits is essential for ensuring that offsetting does not lead to a net global increase in emissions. The use of non-additional offsets therefor directly undermines climate goals. Non-additional offset credits also undermine the economic effectiveness of climate policies by making it more expensive to actually meet the necessary reduction required to stay within the 2 degree limit. In other words, at some point additional money will have to be spent to achieve the reduce emissions sufficiently to stay below 2 degrees warming.

## DOUBLE-COUNTING

Double counting occurs when emissions reductions achieved under an offsetting mechanism are used more than once for meeting climate commitments. Double counting undermines climate goals and economic efficiency and must therefore be avoided. The risk of double counting of emission reductions that are sold as offsets is technically and politically difficult when both the host and buyer countries have reduction targets. Double counting is already a reality for emissions reductions sold under the CDM that originate in developing countries with a reduction pledge for 2020. Under current UN rules a host country that sells CDM offset credits does not have to account for these emissions reductions in their own greenhouse gas accounting. This can lead to double counting because in this case, emission reductions may be counted twice: once by the buyer country who has purchased the CDM offsets and once by the host country, if those emission reductions are reflected in their inventory. It is important to note that all significant CDM host countries have made emission reduction pledges for 2020. Double counting would be avoided if the host country added emissions to their emission inventory equivalent to the number of offsets sold or if the buyer country did not use the units they bought toward meeting their pledge.

A Stockholm Environment Institute policy brief[4] finds that significant additionality concerns are related to large-scale (over 15 MW) hydropower and wind projects, natural gas and higher-efficiency coal power projects as well as projects that generate electricity from waste gases in the iron and steel sector. A quarter of all CDM offsets issued so far come from such power projects. Between 2013 and 2020 it is projected that 70% of all issued offsets credits will come from these large-scale energy projects with questionable additionality.

Under JI, the achieved climate benefits are likely to be even lower. Over 700 million JI offsets have been issued to date, accounting for one third of all Kyoto carbon offsets. Almost 90% of these come from Ukrainian and Russian projects that have very limited transparency and no international oversight.

Double counting of international offsets could further undermine the EU's climate targets (see box).

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## WHY THE CDM HAS FAILED AS A DEVELOPMENT TOOL

The lack of environmental integrity is not the only issue that makes international offsets problematic.

Numerous studies and anecdotal evidence show that many CDM projects fail to deliver sustainability benefits. The reasons for this are manifold. Sustainability benefits have no financial value in the current system, as only greenhouse gas benefits result in monetary compensation through the generation of offset credits. Another reason is that host countries define their own sustainability criteria. Developing countries rejected attempts to establish an international sustainability assessment process, arguing that it would infringe on their national sovereignty. It is in the interests of the host country to secure as many CDM projects as possible because of the investment they bring. The sustainability criteria therefore usually lack specificity, transparency and stringency.

The assessment process that is performed by the host country Designated National Authorities (DNAs) is often perfunctory. Even in the few countries that have well developed sustainability requirements, the requirements are undermined by the lack of monitoring, reporting, and verification of claimed sustainability benefits. Experience shows that for these reasons, the majority of offsets are from projects with arguably little or no sustainable benefits. Despite the large number of CDM power projects, local communities in the vicinities of the projects often do not have access to electricity.

Sometimes the projects even have negative impacts. For example, two registered CDM projects, the Aguán Biogas Project in Honduras and the Barro Blanco Hydropower Project in Panama, were registered despite concerns of human rights abuses. Yet, there is currently no mechanism that allows suspending or deregistering CDM projects. The CDM Executive Board has stated that it has no mandate to investigate human rights abuses. In response, a study[5] by the European Parliament’s subcommittee on human rights has recommended that the EU as the major purchaser of CDM offset credits should ban offset credits generated by projects that violate human rights.

# INTERNATIONAL OFFSETS IN THE 2020 EU CLIMATE LEGISLATION

The EU decided in 2008 to cut its greenhouse gas emissions by 20% below 1990 levels by 2020. The EU's climate target for 2020 is implemented through the EU's Emission Trading Scheme (EU-ETS) and the Effort Sharing Decision (ESD) which defines reduction targets for the non-ETS sectors (e.g. transportation and agriculture) in each EU Member State.

## INTERNATIONAL OFFSETS HAVE UNDERMINED THE EU-ETS

The EU-ETS covers large industrial installations and the power sector in all 28 EU Member States plus Iceland, Norway, and Liechtenstein. The EU-ETS is the largest market for emission permits in the world and includes more than 11.000 installations representing around 40% of all EU GHG emissions. The EU-ETS is currently in its third trading period (2013-2020).

To meet their reduction obligations, covered entities under the EU-ETS can reduce their emission, buy EU-ETS allowances (EUAs) or buy international offsets from the CDM or JI. The 2009 EU-ETS Amending Directive[6] sets a use limit for offsets of up to 50% of the EU-wide reductions below 2005 emissions.

The use of international offset credits in the EU-ETS was originally meant to be a cost containment tool. However, due to the economic crisis, emissions have been substantially lower than the cap. This rendered the quantity limit of international credits in the period 2008 to 2020 too generous and in turn has been a major driver for the build-up of the current surplus of EUAs. According to the recent European Commission report "The state of the European carbon market" , the use of international offsets in the EU ETS has almost doubled the oversupply in the period 2008-2011 and is estimated to amount to three quarters of the oversupply by 2020.

## CURRENT OFFSET RESTRICTIONS INSUFFICIENT

The EU has limited the types of international offsets that could be used in the EU-ETS. Offsets from nuclear facilities and from land use, land use change and forestry have never been eligible under the EU-ETS. In January 2011, the EU extended the ban to CDM offsets from HFC-23 destruction and nitrous oxide destruction from adipic acid plants. The ban took effect on 1 May 2013. These two project types were banned because they led to wind-fall profits, a shift in production and subsequently to an increase in overall emissions. Moreover, recent studies show the lack of environmental quality of other project types, notably large-scale energy projects and projects under Joint Implementation track 1. These have not been addressed so far, neither at the UNFCCC nor the EU level.

## EXTENSIVE OFFSET USE IN THE EFFORT SHARING DECISION

Under the Effort Sharing Decision (ESD) Member States have taken on binding annual targets for reducing their GHG emissions from the sectors not covered by the EU-ETS, such as buildings, agriculture, waste and transport (excluding aviation). Around 60% of the EU's total emissions come from sectors outside the EU-ETS.

The overall EU target under the ESD is a 10% emission reduction in 2020 compared to 2005 emissions. Each Member State has an ESD target determined according to its economic capacity. Significant differences exist between Member States. Some need to reduce emissions compared to 2005 whilst others are permitted a limited growth in emissions. The recent EEA report shows that the EU is already on track to achieve a 15% reduction by 2020.

The use of international credits in the ESD is limited to 3% of each Member State's allowances in 2005. Although this number sounds low, it means that around two thirds of the overall emission reductions required by 2020 under the ESD can be met through the use of international credits.

Furthermore, the ESD allows Member States to transfer part of its unused international credit entitlements to another Member State. In other words, the buyer country can use these entitlements to purchase further international credits above the 3% limit.

The flexibility to carry over, and transfer allowances and international credits between Member States allows for surplus and deficits to be easily rectified. The EEA report also reveals that only six Member States (Austria, Belgium, Finland, Ireland, Luxembourg and Spain) will need to increase their efforts to reach their national targets. Only Belgium, Ireland and Luxembourg have a compliance gap greater than 10%.

## DOUBLE STANDARDS ON QUALITY RESTRICTIONS

As in the EU-ETS, the quality of offset credits is particularly important. However, while quality provisions for the EU-ETS are governed at the European level, the decision on what types of offsets Member States purchase for their ESD targets is taken at Member State level. This means that the ban against offset credits from industrial gases is only valid for the ESD, if a Member State decides to extend the ban. Denmark has initiated a Declaration for Member States to extend the ban to their national ESD targets. However, to date, only 22 out of 28 Member States have done so. At the recent Environment Council meeting in October 2013, Hungary, Ireland, Italy, Lithuania, Poland and Spain refused to sign the Declaration.

On a positive note, some European countries have already gone beyond the quality restrictions placed under the EU-ETS. Norway for example has declared not to purchase carbon offsets from projects that continue regardless of financial support through the CDM, such as large hydro and wind farm projects. The Flemish government has recently announced in a tender that it will not buy credits from large hydro power and coal power projects.

## RECOMMENDATIONS

Concerns about the quality of offset credits, as described above, need to be addressed. This can either be done at the supply side through the UNFCCC or by the buyer, by implementing additional quality restrictions.

The shortcomings of the CDM and JI could be addressed under the UNFCCC. But the likelihood that comprehensive reforms will be passed that would significantly increase the quality of these offsetting mechanisms is low. Despite the stark research findings, countries have shown little willingness to tighten the CDM and JI rules to address the blatant quality flaws. Although the CDM Executive Board has the power to address many of the quality concerns in the CDM, experience has shown that also at the Board level, substantive changes are hindered by politics. Reforms under JI that would sufficiently address the current flaws of JI are even less likely.

Insufficient action at the supply level forces decisions on the buyer side to ensure the environmental integrity of the offsets used for compliance. Putting in place further use restrictions is a vital step to avoid that EU climate legislation is undermined by substandard carbon credits that do not reduce emissions and increase global emissions if used in the EU ETS.

**Carbon Market Watch recommends that offset credits from following project types be banned for use in both, the EU-ETS and the ESD for the period from 2013 – 2020:**

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## About Carbon Market Watch

Carbon Market Watch is a project of Nature Code – Centre of Development & Environment. For more information about Nature Code, see www.naturecode.org. Carbon Market Watch scrutinises carbon markets and advocates for fair and effective climate protection.

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