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Carbon Market Watch

RETHINKING THE ROLE OF INTERNATIONAL CARBON MARKETS IN THE EU'S 2030 CLIMATE FRAMEWORK

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EXECUTIVE SUMMARY

In January 2014 the European Commission is expected to publish a White Paper on the EU's Climate Framework for the period of 2020-2030. The Framework will include a comprehensive policy package that will define climate and energy targets and policies. The EU's Heads of States are expected to decide on EU climate targets for 2030 in March 2014.

The EU will have to reconsider the use of international offsets for the period post 2020. The EU is planning to link to several emerging emission trading systems, and will also need to decide how to link to other such schemes without undermining EU climate targets.

Existing carbon markets have to a large extent not delivered the promised climate benefits. The two existing UN offsetting mechanisms, the Clean Development Mechanism (CDM) and Joint Implementation (JI), have generated over two billion offsets, but the majority of them are of dubious quality. Cap-and-trade systems have suffered from inflexible designs and political resistance to addressing oversupply and other shortcomings, causing large price fluctuations and ultimately a severe price crash.

Nevertheless, many countries are developing new GHG emissions trading schemes and offsetting programmes. 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. The quality and size of these new markets is unknown. Comprehensive rules that would ensure the quality integrity of new markets are unlikely.

The lessons learned from existing markets must be taken into account in the EU's 2030 Climate Framework to ensure that the EU is doing its fair share to protect the global climate.

Carbon Market Watch recommends:

- **A legally binding EU domestic GHG reduction target of at least 55 per cent below 1990 emission levels.**
- **No international offsets for meeting 2030 mitigation obligations.**
- **Structural reforms of the EU ETS and the ESD to ensure they can drive emission reductions.**
- **ETS-linking safeguards that ensure EU climate goals are not compromised.**
- **No carry-over of offsets or allowances from pre-2020 for compliance under the 2030 Climate Framework.**
- **A comprehensive long-term strategy on international climate finance.**

INTRODUCTION

European policy makers are currently debating the design of the EU's Climate Framework for the period of 2020-2030, which will include a comprehensive policy package on climate and energy targets and policies. The European Commission intends to publish a White Paper in January 2014 on the EU's Climate Framework for 2020-2030, and Member States are scheduled to decide on EU targets for 2030 in March 2014.

New GHG emissions trading schemes and offsetting programmes are being developed in many countries. The EU will have to reconsider the use of international offsets for the period post-2020. It will also need to decide on the specifics of linking to other emission trading schemes, taking particular care to avoid undermining EU climate targets by linking to other schemes that are oversupplied or allow for the use of low quality offsets.

This policy brief discusses the role of carbon markets, and in particular international offsets, under the EU's 2030 Climate Framework. It summarises the experience with international carbon offsets under current EU climate legislation, and explains why international offsets should not be used for compliance with the EU's mitigation goals for 2020-2030. It also discusses alternatives to offsets, such as performance-based financing, which could help ensure the EU's fair and effective contribution to climate finance in less-developed countries.

OFFSETTING HAMPERS DOMESTIC ABATEMENT EFFORTS

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 2008-2020 period too generous. The use of international offsets in the EU ETS has almost doubled the oversupply in the 2008-2012 period, and will amount to three-quarters of the oversupply by 2020. Overly generous trading provisions will also enable EU Member States to overachieve the EU's reduction target in the non-ETS sectors without having to implement any new policies and measures.

If the EU had not allowed the use of international offsets, it could have cut its emissions domestically by an additional 1400 million tonnes of emission reductions in the period from 2008-2012 alone.

Experience with the EU ETS and the ESD has shown that the use of international offsets has hampered domestic abatement efforts. For the period 2008-2012, over one billion offsets have been used in the EU ETS. About 400 million will be used by EU Member States for emissions in non-ETS sectors for the same period. This means that if the EU had not allowed the use of international offsets, it could have cut its emissions domestically by an additional 1400 million tonnes of emission reductions in the period from 2008-2012 alone. This is especially troubling given the low quality of international offsets.

> **Eliminating access to international credits after 2020 would help ensure a stronger focus on domestic abatement and spur investment in low-carbon technologies in EU industry.**

> **Surplus allowances and offsets should not stifle action after 2020, and should therefore not be carried over for compliance under the 2030 Climate Framework.**

LOW QUALITY OFFSETS UNDERMINE EU CLIMATE GOALS

Offsetting mechanisms aim to reduce the overall costs of GHG mitigation 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. Thus, when offsets do not represent additional emission reductions over and above what would otherwise have occurred, their use actually increases global emissions.

Current rules for additionality 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. Recent research estimates that the CDM has likely delivered less than 40 per cent of the emission reductions it sold. The study further estimated that 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 gigatonnes CO2e through 2020. Under JI, the achieved climate benefits are likely to be even lower. Almost 90 per cent of all JI offsets come from Ukrainian and Russian projects with very

limited transparency and environmental oversight.

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.

International offsets undermined the EU's climate goal by 840 million tonnes under the first Kyoto commitment period.

In the EU, over one billion offsets were purchased under the second trading period of the EU ETS alone (2008-2012). Another 400 million will probably be used by Member States to meet their non-ETS targets for the same period. If we assume that these offsets achieved only 40 per cent of the claimed emission reductions, the use of international offsets undermined the EU's climate goal by 840 million tonnes under the first Kyoto commitment period. If no changes are implemented, then it is likely that the EU's climate goals until 2020 will be further weakened by several hundred million tonnes. (In comparison, total EU GHG emissions were about 3600 million tonnes in 2012).

In response to the overwhelming evidence for the low quality of offsets, the EU put in place some quality restrictions, but these are far from comprehensive.

› Offset credits from clearly detrimental project types should be banned immediately from use in the EU, including industrial gas projects, large-scale power projects, and all JI track 1 projects.

INTERNATIONAL CARBON MARKET DEVELOPMENTS

Over 1.3 million offsets under the CDM and almost 830 million offsets under JI have been issued to date. As many as six billion could be issued by 2020. Yet the demand for offsets is barely three billion. All major emission trading schemes are currently severely oversupplied. International Emissions Trading under the Kyoto Protocol generated 14 billion tonnes of "hot air", the EU ETS is oversupplied by two billion and under the ESD, trading of allowances is expected to be minimal due to almost no demand. Prices for CDM offsets have plummeted from around 15 to less than 0.5 EUR in the last two years. Given the lack of demand, prices will likely remain this low for the foreseeable future.

Despite the large oversupply of emissions allowances and offsets, new GHG emissions trading schemes and offsetting programmes are being developed in many parts of the world. China, California, Korea, Chile, Quebec, and 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 promoting the development of such new market schemes.

Under the UNFCCC countries are currently negotiating if and how such new carbon markets should be governed internationally, and if and how allowances or offsets from such new markets can be used to meet mitigation commitments. Stringent and comprehensive UN rules and governance structures could help preserve a minimum level of environmental integrity. But it is unlikely that countries will agree to such rules because many are advocating for little or no international oversight. Moreover, the absence of ambitious climate targets and lack of eligibility requirements for access to global carbon markets do not bode well for the possibility of an international carbon market with environmental integrity.

LINKING OF EMISSIONS TRADING SCHEMES

Independent of the outcome in the UNFCCC negotiations, the EU is already working towards linking with other emission trading schemes. The EU and Australia announced an agreement in August 2012 on a pathway for linking the EU ETS and the Australian emissions trading scheme. The agreement foresaw a full two-way link between the two cap-and-trade systems starting no later than mid-2018. Under this arrangement, businesses would be able to use carbon units from the Australian ETS or the EU ETS for compliance under either system. However, given the political situation in Australia, it is currently unclear whether the two schemes will be linked as planned. The EU is also negotiating with Switzerland on linking the EU ETS with the Swiss ETS, and has expressed interest in linking to other emerging schemes in the future.

Linking could potentially compromise climate goals in several ways. For example, the Australian ETS allows the use of forestry credits while the EU ETS does not. The use of low quality offsets in one of the schemes will compromise mitigation efforts under both, even if such offsets cannot be used directly in the EU ETS.

In addition, if one ETS is oversupplied, it will compromise the effectiveness of the linked ETS as well. This is because the scheme with an allowance shortage would simply meet its demand by buying allowances from the oversupplied ETS.

Furthermore, double-counting could compromise the integrity of linked schemes. Double-counting occurs when emission reductions achieved under a trading mechanism are used more than once for meeting climate commitments. Double-counting undermines climate goals and economic efficiency, and must therefore be avoided. The accounting of emission reductions and ensuring that these are only counted once becomes increasingly complex when different systems with different rules are linked.

> Simply banning offsets under the EU's 2030 Climate Framework is not sufficient to ensure the effectiveness of the EU ETS. Additional safeguards are necessary to prevent lower quality offsets eligible under other linked trading schemes from undermining the EU ETS.

ENSURING EFFECTIVE AND SUFFICIENT CLIMATE FINANCE

Climate markets are often promoted as climate finance, but if a country buys emission reductions from a developing country, those investments should not also be counted as financial contributions to the host country. This would result in a type of double-counting and could therefore lead to less investment and climate finance in poorer countries.

In addition, carbon markets are in many cases not the most efficient use of funds to achieve comprehensive long-term decarbonisation. Carbon markets target low cost mitigation opportunities, which may not bring the needed long-term change.

Addressing climate change requires a broad, well-coordinated set of market-based and non-market based policies. The core of the climate problem is keeping to an extremely stringent global emission budget, while at the same time supporting low-carbon sustainable development and adaptation to the impacts of climate change. In other words ambition and equity are, inevitably, the two sides of any viable global climate agreement. The climate crisis requires all countries to collaborate and act. In particular, the climate talks cannot succeed unless we face the challenges of "equitable access to sustainable development."

Countries are currently negotiating a new climate deal. Under the Ad Hoc Working Group on the Durban Platform

for Enhanced Action (ADP), countries are aiming to develop a global climate agreement that would include all countries and start in 2020. But sealing a deal that is ambitious enough to stabilise climate change below the 2°C threshold will require a coalition for ambition of developing and developed countries that support a legally-binding international regime. In order to successfully build these alliances, the EU must scale-up financial support for the more vulnerable countries to meet its existing commitment under the UNFCCC, and contribute to the annual 100 billion dollar target by 2020. This includes making initial pledges to the Green Climate Fund and pledging to the Adaptation Fund whose main revenue stream (2 per cent of CER auctioning revenue) is diminishing rapidly.

The EU also needs to develop a comprehensive long-term strategy on international climate finance that ensures the EU's financial contributions towards addressing the global climate crisis are sufficient, predictable and effective.

The financial support of mitigation and adaptation action in developing countries is vital, but it cannot come at the cost of stifling mitigation action in Europe. Instead Europe must look at innovative approaches to ensure sufficient and effective climate finance for less-developed countries. This could include performance-based finance of mitigation action in less-developed countries, such as the financial support of nationally appropriate mitigation actions (NAMAs).

At the UNFCCC negotiations in Bali in 2007, developing countries agreed to develop such NAMAs. NAMAs aim to reduce GHG emissions while also achieving sustainable development and poverty reduction objectives. NAMAs have been loosely defined, and can include individual mitigation projects and actions or comprehensive sector-wide mitigation programs. Numerous developing countries have started to develop NAMA proposals and a number of developed countries including Germany, Denmark, Canada and Norway, are providing funding to support the development of NAMAs.

Double-counting of financial obligations and emission reductions must be avoided. For the EU countries that chose to fulfil part of their climate finance obligations by purchasing international offsets, these offsets will have to be cancelled. They cannot be used to meet mitigation commitments. If they are to be used, only offsets with high environmental and social integrity should be allowed for the purpose of meeting climate finance obligations. Purchasing low quality offsets, such as the majority of current CDM offsets, would not only undermine the EUs credibility but would also simply be a waste of scarce financial resources.

> Only offsets with high environmental and social integrity should be allowed for the purpose of meeting climate finance obligations.

> The role of offsets as a climate finance tool is limited. We recommend that climate finance measures focus on other policy instruments – regulation, standards and incentive programs – that can in many instances achieve more cost-effective long-term abatement than carbon markets. projects, and all JI track 1 projects.

RECOMMENDATIONS

Existing carbon markets have drastically underperformed. The quality of offset credits has been insufficient in many cases, and the willingness to strengthen rules to improve their environmental integrity has been low. Cap-and-trade systems have been undermined by inflexible designs and a lack of political will to rectify oversupply and other issues, leading to large price fluctuations and eventually a price crash. Such unstable markets do not provide the necessary long-term price signals that are needed to facilitate a sustainable low-emissions pathway. To ensure that the EU is doing its fair share to protect the global community from the effects of catastrophic climate change, Carbon Market Watch recommends:

AN AMBITIOUS CLIMATE TARGET OF AT LEAST 55 PER CENT DOMESTIC ACTION

A legally binding EU domestic GHG reduction target of at least 55 per cent below 1990 emission levels is necessary to ensure the EU reaches its decarbonising goal of 80-95 per cent by 2050.

The 2030 framework needs to include ambitious, coherent and binding EU-wide and national targets for emission reductions, energy savings, renewable energy production and international climate finance. As confirmed by the International Energy Agency, three legally binding targets will be more effective in delivering the domestic mitigation required to reduce the risks of dangerous climate change than a system based on carbon price alone.
These three targets can help ensure long-term investment certainty and remove non-market barriers.

NO INTERNATIONAL OFFSETS FOR MEETING MITIGATION OBLIGATIONS

Eliminating access to international credits after 2020 will help ensure a stronger focus on domestic abatement and spur investment in low-carbon technologies in Europe.

IMPLEMENT IMMEDIATE SUBSTANTIAL REFORMS OF THE EU ETS AND ESD

Both the EU ETS and the ESD need to be reformed now to ensure that they drive emission reductions. Structural reform of the current ETS is urgently needed before 2020 to ensure the new 2030 framework can deliver sufficiently ambitious reductions. Under the EU ETS, the annual linear reduction factor should be increased to 2.6 per cent and 2.2 billion EU allowances should be permanently cancelled. International offsets from non-additional and clearly detrimental project types should be banned immediately from use in both the EU ETS and the ESD.
These project types include industrial gas projects, large-scale power projects including coal, and all JI track 1 projects.

DEVELOP ETS-LINKING SAFEGUARDS

The EU intends to link its ETS to several emerging emission trading systems. Such linking risks compromising the integrity of the EU ETS if the linked systems are oversupplied or allow the use of low-quality offsets. The EU must develop clear rules and safeguards that ensure linking does not compromise ambitious EU GHG reduction targets.

NO CARRY-OVER OF OFFSETS AND ALLOWANCES TO A POST-2020 FRAMEWORK

Large oversupplies of allowances and offsets are projected to accumulate both under the EU ETS and the ESD. These surpluses should not stifle action after 2020. Allowances equivalent to the size of the surpluses in the EU ETS and the ESD should be retired at the end of 2020. CDM and JI offsets should not be carried over for compliance under the 2030 Climate Framework.

DEVELOP COMPREHENSIVE LONG-TERM STRATEGY ON INTERNATIONAL CLIMATE FINANCE

Despite repeated statements by finance ministers that the EU will do its fair share (30-40 per cent of the global figure) in providing financial resources for developing countries, and in particular the Copenhagen promise to mobilise 100 billion USD annually by 2020, financial commitments have been woefully inadequate. The EU should develop a comprehensive long-term strategy on international climate finance, beyond investing in carbon markets, which ensures the EU's financial contributions to addressing the global climate crisis are both sufficient and effective.

Moreover, double-counting of emission reductions and financial obligations must be avoided. Any EU countries that purchased international offsets to fulfil part of their climate finance obligations would need to have these particular offsets cancelled. Such offsets cannot be used to meet mitigations commitments. Should it be decided to allow this practice, only offsets with high environmental and social integrity should be eligible . However, offsets have a limited role as a climate finance tool. We recommend that other policy instruments, such as regulation, standards and incentive programs, should be the focus of climate finance measures, as these can in many instances achieve longer-term and more cost-effective abatement than carbon markets.

The 2030 Framework is the crucial milestone in the EU's climate policy. Political discussions around the 2030 climate package are expected to be intense, and will need to be made over a short period of time. It is of vital importance to implement reforms immediately that will pave the way for an ambitious, comprehensive and fair 2030 Climate Framework.

About Carbon Market Watch

Carbon Market Watch scrutinizes carbon markets and advocates for fair and effective climate protection.
For more information see www.carbonmarketwatch.org

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i. Directive 2009/29/EC, Official Journal of the European Union, 5.6.2009, L140/63
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:140:0063:0087:en:PDF

ii. The state of the European carbon market in 2012, European Commission report, 14.11.2012, COM(2012) 652 final
http://ec.europa.eu/clima/policies/ets/reform/docs/com_2012_652_en.pdf

iii. Trends and projections in Europe 2013 – Tracking progress towards Europe's climate and energy targets until 2020
http://www.eea.europa.eu/publications/trends-and-projections-2013

iv. Ibid.

v. Assessing the Impact of the CDM. Report Commissioned By The High-Level Panel On The CDM Policy Dialogue, July 2012
http://www.cdmpolicydialogue.org/research/1030_impact.pdf

vi. See endnote iii

vii. 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 windfall profits, a shift in production and subsequently to an increase in overall emissions.

viii. See also our policy brief: The Elephant in the Room:
International Offsets in EU's 2020 Climate Legislation

ix. Rules and information on linking of the EU ETS can be found here:
http://ec.europa.eu/clima/policies/ets/linking/documentation_en.htm

x. Summing up the parts: Combining Policy Instruments for Least-Cost Climate Mitigation Strategies, Christina Hood, International Energy Agency, 2011

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