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

Introduction

The EU Emissions Trading Scheme (EU ETS) is a crucial cornerstone of climate change policy in the UK and Europe. Phase II of the scheme (2008-2012) will be a real test as to whether market based mechanisms can deliver significant emissions reductions in the EU.

In addition to the lax caps proposed by many member states and the low uptake of auctioning as a way to allocate allowances, many Member States have also proposed maximum limits on the use of imported project credits[1] far in excess of the level of effort for phase II and some have proposed no limits at all. 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, however, 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 which 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 home[2].

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 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).

The preliminary findings of this study, as interpreted by WWF, are given below. A full report will be released later in the year.

Preliminary 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 annual shortage in the EU countries analysed is **between -10 and -60 million tonnes of carbon dioxide ($MtCO_2$) per year**. This range was

[1] 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.

[2] 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."

calculated by assessing the difference between the proposed caps and where available Member States official BAU emissions projections (which gave the higher figure). 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 BAU based on PRIMES projections (which gave the lower figure)[3]. The lower figure (-10 $MtCO_2$) equates to a cap which is only 0.6% below the PRIMES calculated business as usual emissions projections.

- **Allowed use of JI/CDM credits is significantly larger than the expected shortage so all abatement could potentially take place outside the EU** – The initial findings showed that for the countries analysed there was a theoretical maximum of at least **280 $MtCO_2$ 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, some countries (for example Portugal) have chosen not to set restrictions and so this theoretical maximum could actually be exceeded. In summary, therefore, the scheme will only ever be as strong as its weakest link.

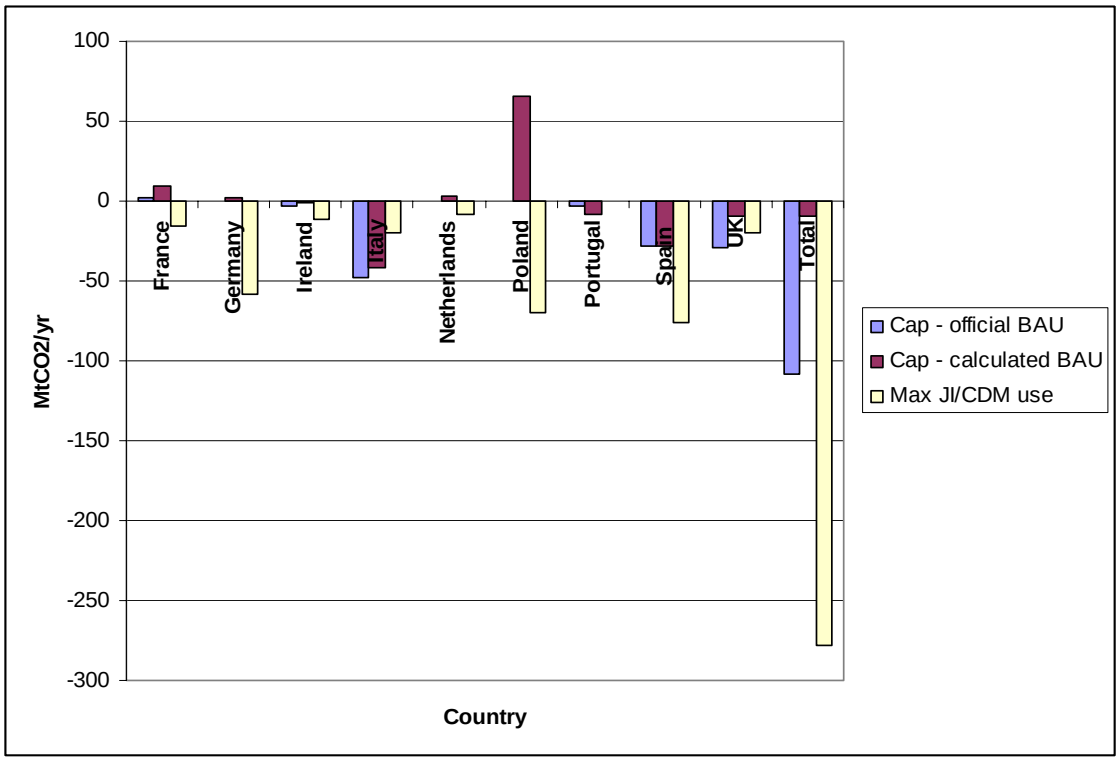

Figure 1 Proposed Phase II cap minus official and calculated (from PRIMES data) ETS sector BAU figures and theoretical maximum JI/CDM credit use[4].

- **Allowed use of JI/CDM credits in phase II of the EU ETS is likely to be below the expected global supply once the potential use by governments to meet their Kyoto targets is taken into**

[3] 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.

[4] Note that the proposed phase II caps minus official BAU emissions projections for both Netherlands and Poland is close to zero, whilst information on BAU emissions projections was absent from the German NAP and is therefore not given here.

account. Supply of credits is estimated to be around 400 $MtCO_2eq$ per year during 2008-2012 - with a possible range of between **200 and 600 $MtCO_2eq$ per year**. A conservative global demand from governments is estimated at 130 $MtCO_2eq$ per year.

- **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 Clean Development Mechanism is to help developing countries achieve sustainable development. Industrial gas abatement projects often 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 shortage.** It is estimated that around 110$MtCO_2$ per year technical emissions reduction potential exists within the industrial sectors 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 relatively easily achievable. This is in excess of the lower end of the range for the estimated shortage across the 9 NAPs analysed (-10 $MtCO_2$ 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.

Preliminary conclusions:

In summary we can preliminarily 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 -10 and -60 $MtCO_2$ per year for the countries analysed) will be very small. Indeed the proposed use of project credits could fill this gap many 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 should be made significantly tighter.
- All member states should be required to set a limit on the maximum use of project credits in line with the requirements of the ETS Directive.
- In addition to this, and 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 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.

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.