

Memorandum submitted by the Sandbag Climate Campaign

Summary

- In principle the EU ETS is an effective instrument to deliver low-cost abatement and provide maximum flexibility for the sectors it covers, but in practice the ETS carbon budgets have been consistently set too high. Policymakers need to revise the caps downward.
- For the instrument to fulfil its potential and align with Europe's longer term goals, Sandbag recommends that 1.7Gt be set aside from the permits auctioned in the Phase 3 budget and the trajectory be amended to a 2.4% annual decline at the earliest opportunity.¹
- Despite being oversupplied to date the EU ETS price signal is estimated to have driven some 330Mt of CO₂ to date. Phase 3 will ensure 2.7 billion tonnes of CO₂ are saved against current business-as-usual projections for 2013-2020.²
- While the future of the Kyoto Protocol is uncertain, domestic and regional cap-and-trade schemes are multiplying, with several comparable schemes in place already (New Zealand, Switzerland, Eastern States of the USA) and still more due to be operational between 2012-2016 (California, Australia, South Korea, Ukraine and even China).
- The barriers that inadequate international climate action present to more ambitious European climate policy, or that inadequate European action present to UK climate policy, have been exaggerated by competitively-exposed and energy intensive industries. These industries are offered extensive protections by the Emissions Trading Directive in Phase 3 and are currently profiting from the scheme in Phase 2.

1. Sandbag is a UK-based climate change NGO focussing on environmental reform of the EU ETS. Through producing rigorous but accessible analysis, we aim to make emissions trading more transparent and understandable to a wider audience than those directly involved in the carbon market. Our view is that if emissions trading can be implemented correctly it has the potential to help deliver the deep cuts in carbon emission the world so badly needs to prevent the worst impacts of climate change.

The politics of the EU ETS

2. The EU ETS was able to attract a broad political base to support its implementation because it combined the flexibility of a liberal market mechanism with the hard political regulation of a cap. Since its adoption, though, public comment on the system has been hijacked by market-sceptics on the left and climate-sceptics on the right, who both aggressively call for the EU ETS to be dismantled.

3. This excessive politicization of the European trading system has become a distorting lens through which its imperfections have been perceived, turning each technical or environmental challenge it faces into a call for its termination. These challenges should instead be perceived as opportunities

¹ Sandbag, *Buckle Up! The 2011 Environmental Outlook for the EU ETS* (July 2011)

http://www.sandbag.org.uk/site_media/pdfs/reports/Sandbag_2011-07_buckleup.pdf

² p.15 of *Buckle Up!* drawing upon *Pricing Carbon* (Ellerman, 2010) and *Hard to Credit* (Deutsche Bank, 2010)

for constructive engagement and reform with what is, fundamentally, a powerful policy whose major fault is that it currently lacks sufficient ambition.³

4. Those agencies who have taken an engagement approach have had considerable success in repairing the very weaknesses that the scheme's most vociferous critics have used to damn it: from 2013 offset credits from the most controversial industrial gas offset projects will be ineligible, new CDM offsets must come from projects in Least Developed Countries, electricity sector windfalls from passed-through opportunity costs will end, industrial sectors should no longer be able to accrue surplus permits, and new security features will reduce the opportunities for fraud.

5. There are long lead times before these changes can be implemented, but this highlights the need for early and far-sighted intervention from policymakers seeking ETS reform.

The viability of the EU ETS in delivering European abatement

6. The EU ETS remains a viable instrument for limiting EU emissions, with the traded sector expected to deliver roughly 2/3rds of Europe's 2020 emissions reductions under all scenarios currently tabled.

Table 1: 2020 GHG reduction scenarios accompanying the May 2010 Communiqué

2020 scenario	Summary	EU %below 1990	EU %below 2005	ETS %below 2005	Non-ETS %below 2005
2009 Baseline	Enacted policies as of Spring 2009	14%	7%	11%	3.5%
Reference	Full implementation of 20:20:20 package	20%	14%	19%	9.5%
30% Flexible	25% internal, 5% state offsets	25%	19%	26%	13%
30% Domestic	30% internal	30%	24%	34%	16%

Source: Compiled from different tables in SEC (2010) 650

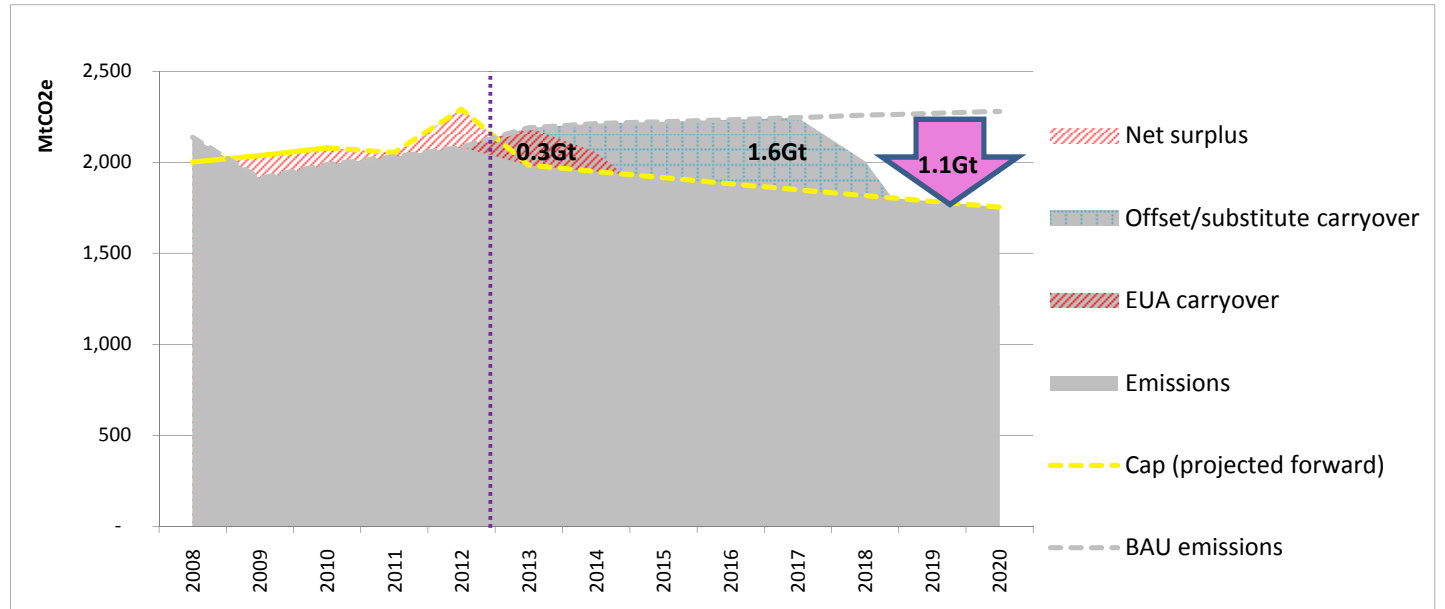
7. At present, however, the domestic emissions reductions in the EU ETS have predominantly been delivered by the recession, with a disproportionate share of active abatement being outsourced to foreign countries through offset credits. This is money that could be better spent on new energy infrastructure within Europe, protecting the region from volatile fossil prices and demonstrating clean development to emerging economies. As we discuss below, complementary policies in the EU climate package are also likely to eclipse the Phase 3 cap.

Emissions reductions delivered by the EU ETS at home and abroad

8. Over 2008-2020 the EU ETS cap ensures emissions will be reduced by **2.7Gt** against business-as-usual levels on current economic trends. This consists of 1.6Gt of offsets and 1.1Gt of domestic abatement.

³ See p.13-14 of *Buckle Up!* www.sandbag.org.uk/site_media/pdfs/reports/Sandbag_2011-07_buckleup.pdf

Figure 1: When does the ETS constrain BAU emissions? (Phase 2 scope)

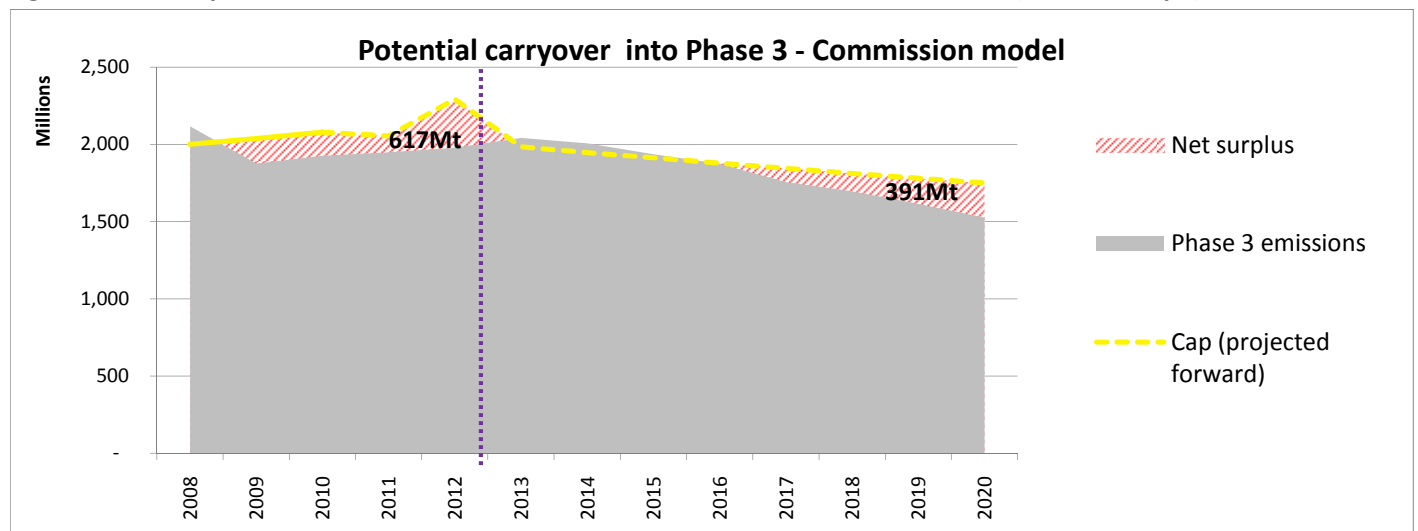


Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2008-2020 Total
BAU emissions	2,137	1,913	1,988	2,030	2,083	2,191	2,213	2,224	2,235	2,246	2,258	2,269	2,280	28,067
Max emissions (using offsets)	2,137	1,913	1,988	2,030	2,083	2,191	2,213	2,224	2,235	2,246	2,161	1,765	1,729	26,915
Max emissions (no offsets)	2,137	1,913	1,988	2,030	2,083	2,191	2,054	1,911	1,874	1,838	1,802	1,765	1,729	25,315

• BAU estimates from Deutsche Bank. Phase 2 allocations from CITL and EU website. Scope controlled Phase 3 allocations and carryover from author's calculations.

9. However, over this period the European Commission projects that the complementary policies from the Renewable Energy Supply Directive and the Energy Efficiency Directive will combine with the effects of the recession and the ETS to drive emissions *lower* than the cap by roughly **1Gt** before any recourse to offsetting, as we see in the diagram below.

Figure 2: Net Surpluses accrued in the Commission's reference scenario 2008-2020 (Phase 2 scope)



Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Cap	2,001	2,038	2,080	2,054	2,292	1,984	1,947	1,911	1,874	1,838	1,802	1,765	1,729
Emissions	2,118	1,876	1,926	1,950	1,978	2,042	2,008	1,938	1,875	1,757	1,697	1,615	1,527
Surplus	-117	161	154	104	314	-58	-61	-27	-1	81	105	150	202
					Phase 2 surplus	617						Phase 3 surplus	391

10. This means we can expect the full climate package to deliver **4Gt** of *domestic* emissions reductions over 2008-2020 against business-as-usual levels. Despite domestic emissions falling

below the cap, we can also expect the **1.6Gt** offsetting allowance available for this period to be fully exhausted, reducing Europe's *total* emissions **5.6Gt** below business-as-usual levels.

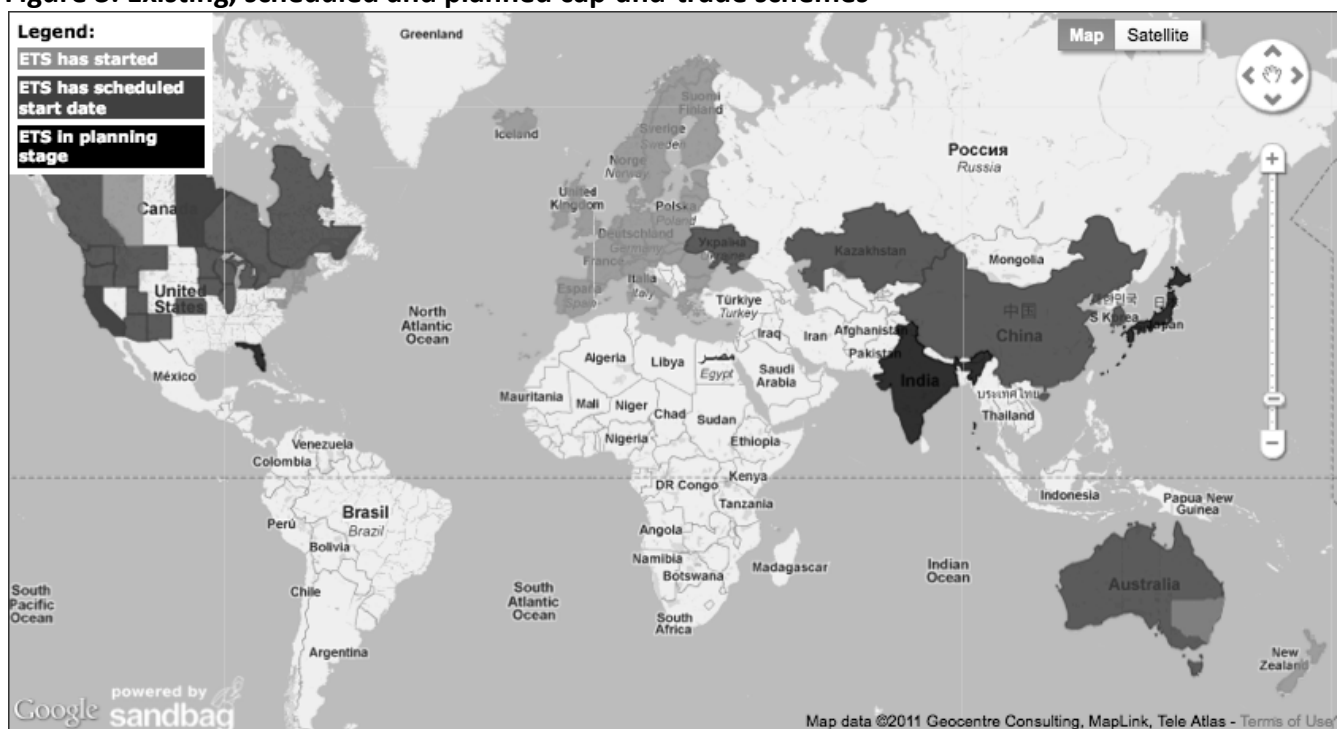
11. These reductions fly well ahead of the ETS cap and will effectively store up **2.1Gt** of domestic emissions rights for use beyond 2020 (1Gt of domestic savings plus 1.6Gt in substituted offsets minus 0.5Gt absorbed by aviation). This is equivalent to more than a year's worth of emissions from the traded sector.

12. In short the ETS is not currently complementary with the other policies in the climate package and instead threatens to store up the emissions saved through external circumstances and policies for use beyond 2020. The ETS cap needs to be revised in order to capture these reductions.

The effectiveness of the EU ETS independent of a global regime

13. The EU ETS can function independently of the Kyoto regime or other cap-and-trade systems, but it is currently a remote possibility that it will need to, with similar systems due to be established between 2012 and 2016 in California, Australia, South Korea, Ukraine, and China.

Figure 3: Existing, scheduled and planned cap-and-trade schemes



14. While the EU ETS can work to uncover lowest cost abatement opportunities within Europe, these opportunities will be more numerous if the scope of the scheme is expanded, either to new sectors of the European economy or to compatible cap-and-trade systems elsewhere in the world.

15. With the EU ETS currently the largest buyer of offsets within Kyoto Flexible Mechanisms (CDM and JI), Europe is well placed to control the terms on which it continues to accept these credits. Europe has already begun to dictate its own quality requirements for CDM entering the EU ETS from 2013, prohibiting the use of HFC-23 or adipic acid N₂O industrial gas credits and refusing credits from all but Least Developed Countries for projects registered after 2012. There remains scope for further quality restrictions to be implemented. Again, because of the concentration of demand for offsets in the EU ETS, Europe is well placed to establish alternative offsetting mechanisms if Kyoto Flexible Mechanisms are discontinued at UN level.

Promoting compatible cap-and-trade schemes and sectoral agreements elsewhere

16. Sandbag has prepared several papers making recommendations for new regions exploring emissions trading based on our experience of the EU ETS.⁴

17. We generally recommend that new regions considering cap-and-trade exclude competitively-exposed sectors and begin with the electricity sector. Competitively-exposed industries risk weakening the scheme both through demands for generous free allocations and through lobbying for weaker overall caps. While energy intensive industries are still likely to resist or weaken electricity sector caps, we suspect this lobbying will be less intense, and the concessions to these industries will be smaller and simpler than if they are direct participants in the scheme.

18. Europe would face reduced carbon leakage threats if its main competitors in exposed sectors adopted similar cap-and-trade policies. In this regard it is promising that neighbouring countries such as Turkey and Ukraine⁵ are considering cap-and-trade schemes. In addition, the Californian and Australian emissions trading schemes cover exposed industries and China is currently considering cap-and-trade schemes for its cement and steel sectors.⁶

19. Europe can accelerate the adoption of cap-and-trade systems firstly by exploring the potential to link compatible schemes and secondly by reducing the eligibility of offset credits generated in projects from competing industries in emerging economies, which potentially disincentivize domestic target-setting.

20. If Europe genuinely experiences a net competitive disadvantage in applying a carbon price on its industrial emissions, it could consider amending the scheme so that imports of products from countries are required to pay a carbon price at Europe's borders. The proposed Californian trading system includes a provision for a carbon price to be applied to imports of electricity from neighbouring states; the EU should consider the introduction of similar provisions. This is particularly important for Eastern Member States who share borders with uncapped countries

21. As Europe explores new sectoral crediting mechanisms to expand or replace its current offsetting provisions, it should avoid providing disincentives to developed or emerging economies to adopt domestic carbon regulations. It should also ensure that the offsets purchased do not subsidize Europe's industrial competitors and exacerbate the risk of European operations shifting abroad. New sectoral agreements could avoid this by purchasing credits from competitively-insulated sectors such as electricity, land transport and heating and by targeting least developed countries.

The relationship between the EU ETS and unilateral action by Europe and its Member States

22. Just as inertia in global climate ambition should not be used as an excuse to hold back ambition in Europe, inertia in European ambition should not be used as an excuse to delay ambition in the UK or other Member States. Climate initiative needs to begin somewhere.

⁴ See for example www.sandbag.org.uk/site_media/pdfs/reports/Lessons_from_ETS.pdf We have also made submissions to the Californian government, the Australian government and met with Chinese state officials on this issue.

⁵ <http://www.elaw.org/node/3743>

⁶ <http://af.reuters.com/article/metalsNews/idAFL3E7J407J20110804>

23. The harmonisation of the EU ETS cap does mean, however, that additional action in the traded sector by individual Member States (be it through more stringent domestic carbon budgets, price floors or energy policies) will not affect the total supply of carbon in the cap and will instead weaken the obligation to decarbonise elsewhere in Europe. But rather than being seen as an excuse for inaction, additional ambitions at Member State level should be used to leverage greater ambition at European level, and within the EU ETS in particular.

24. The UK's ambitious 4th carbon budget covering the period 2023-27 includes a review clause in 2014. This is explicitly to take into account the progress, or lack thereof that Europe has made towards tightening caps in the ETS. In effect this creates a deadline for the EU to act – if it fails to, then the ETS will be guilty of holding back British climate ambition rather than stimulating it.

25. The loudest voices opposing unilateral action at both national and European level are competitively-exposed industries and energy intensive industries. It is important to highlight that competitively-exposed industries policed by the EU ETS have enjoyed some of the largest surplus free allocations throughout Phase 2 as a consequence of their intense lobbying of Member States during the setting of the National Allocation Plans followed by the drop in emissions resulting from the recession. Far from punishing these industries, the sale of surplus carbon allowances has been a source of immediate revenue to them, or presents a buffer of extra permits to cushion them against their benchmarked free allocations in Phase 3.⁷

26. It is also worth noting that the Emissions Trading Directive offers both competitively-exposed industries and energy intensive industries extensive protections in Phase 3. Competitively-exposed industries receive 100% free allocations as benchmarked against the most carbon-efficient installations in their sector and State Aid rules allow Member States to protect compensate energy intensive industries for the effects of the carbon price on their electricity costs.

27. For sectors in both categories it seems to us particularly perverse that the companies who have weakened the ETS caps by resisting responsibilities to abate within it, are now obstructing increased action in the power sector.

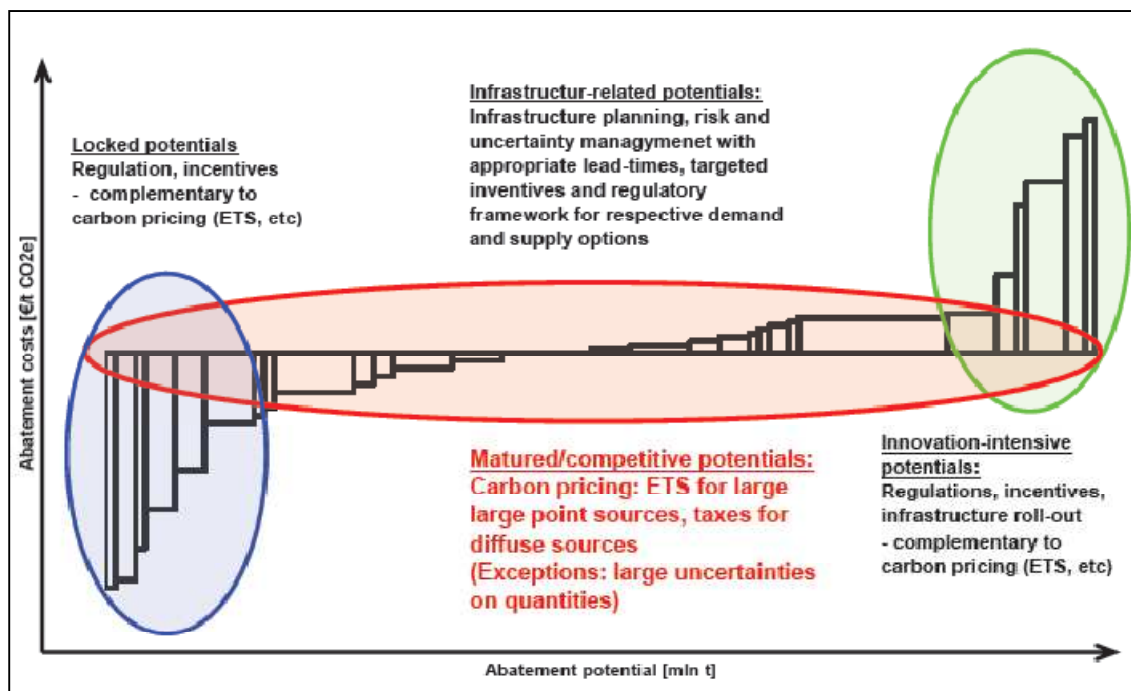
28. We must also question the sincerity of some company's appeals for Britain and Europe to wait for multilateral action before embarking on ambitious unilateral policies. Research by CAN-Europe in their report "Think Globally, Sabotage Locally"⁸ has found suggestive evidence that multinational companies that currently advocate Europe wait for more ambitious global commitments are simultaneously bankrolling efforts to scupper climate change measures in the US.

29. Vested interests have used similar arguments to weaken the Energy Efficiency Directive or renege on the Renewable Energy Supply Directive, but again, the ETS should not be used as a barrier to these policies, but should be made complimentary with them by adjusting down the cap to reflect any overlap between the instruments. The EU ETS is designed to uncover and exploit low-hanging fruit, but the RES Directive will drive innovation and bring new technologies to market, while the EE Directive will unlock negative cost abatement that the ETS cannot access.

⁷ See p.20-24 of *Buckle Up!* www.sandbag.org.uk/site_media/pdfs/reports/Sandbag_2011-07_buckleup.pdf and our latest Carbon Fatcats report at www.carbonfatcats.eu

⁸ http://climnet.org/index.php?option=com_docman&task=doc_download&gid=1788

Figure 4: Relevance of different policies across the Marginal Abatement Cost curve



(Source: Öko institute)

Strengthening the EU ETS to operate effectively

30. As we have seen above, going forward from 2020 the environmental effectiveness of the EU ETS cap can expect to be weakened by some **2.1Gt** of permits carried forward as a result of external policies and recession over 2008-2020. It is unacceptable that these two trading periods serve mainly to retard the progress of the scheme going forward.

31. *As a minimum*, Sandbag recommends that a quantity of permits be set aside from auctions to reflect the impacts of the Energy Efficiency Directive on Phase 3. Estimates within the Commission's own impact assessment find the 2020 carbon price dropping to €14 or even €0 (down from forecasts of €25) if no such adjustment is made.⁹

32. Our *preferred recommendation* would be that the Phase 3 caps are adjusted by 1.7Gt to correct for the direct and indirect effects of oversupplying permits to industrial sectors in Phase 2:

- **Direct effects:** Industrial sectors stand to receive some 855Mt of superfluous permits over Phase 2. While demand from the power sector absorbed some 183Mt of this over 2008 and 2009, the remaining 672Mt can carry forward to weaken Phase 3. We contend that this 672Mt be set aside from the Phase 3
- **Indirect effects:** As Phase 3 caps are defined in relation to average Phase 2 caps they are inflated by the excess permits that were awarded to the industrial sectors. If we adjust the Phase 3 caps and instead calculate them in reference to industrial *emissions* since 2005, this removes 1Gt from the Phase 3 cap.

33. A 1.7Gt set-aside to adjust for industrial oversupply, would largely protect the scheme from the overlaps with the Energy Efficiency Directive and Renewable Energy Supply Directive as a co-benefit. We are not proposing that the set-aside should be removed from competitive industry free allocations but rather that the sum should be held back from

⁹ www.sandbag.org.uk/site_media/uploads/20110505_Impact_Assessment_Energy_Efficiency_Directive.pdf

allowances made available at auction – effectively removing them from the power sector who will continue to be the scheme’s biggest buyers.¹⁰

34. We recommend that the Emissions Trading Directive be re-opened at the earliest political opportunity, in order to permanently cancel this set-aside and prevent these permits from re-entering the market at a later date. We contend that the Emissions Trading Directive be reopened no later than 2015, immediately following the publication of the 5th IPCC report, but European policymakers should ideally move to take action prior to 2014 to prevent triggering the aforementioned review of Britain’s 4th carbon budget.

35. Upon reopening the Directive, it is also pivotal that the rate of contraction in the cap be accelerated from an annual increment of 1.74% to at least 2.4% in order to align with Europe’s 2050 goals for the traded sector. Were this 2.4% increment applied from 2016 some 553Mt of any set-aside would effectively be absorbed by 2020 (a 1.7Gt set aside would be absorbed by 2027). Without intervention, no revision to this 1.74% decline is scheduled to be implemented until 2025.¹¹

36. Finally, as part of a review of the Emissions Trading Directive, we would like to prevent installations with surplus EUAs from surrendering offset credits for compliance. Currently some 57% of the offsets surrendered into the EU ETS have been from installations with free carbon permits to spare. This suggests that offsets are being used as an arbitrage opportunity to profit from the scheme while driving low carbon investment outside of Europe. We would also like to see restrictions placed on any carbon offsets which risk exacerbating leakage of industrial operations outside of Europe.

¹⁰ See p.39-41 of *Buckle Up!* www.sandbag.org.uk/site_media/pdfs/reports/Sandbag_2011-07_buckleup.pdf

¹¹ See p.44-45 of *Buckle Up!* www.sandbag.org.uk/site_media/pdfs/reports/Sandbag_2011-07_buckleup.pdf