Quality restrictions on the use of credits from industrial gas projects

Enel-Endesa response to EC Consultation

We are now approaching the Conference of the Parties of the UNFCCC to be held in Cancun in December. Among the key challenges for climate negotiators, Enel-Endesa and the European electricity industry as a whole see the expansion of the current role of offsets mechanisms as a key element for a global approach to curb carbon emissions. Offsets in the post-2012 framework are expected to lower overall mitigation costs and facilitate international technology transfer by encouraging financial flows from developed to developing countries.

The most promising option relies on the enhancement of the current CDM/JI, which, although requiring improvements, has proven its effectiveness in allowing for the implementation of emission reduction projects in developing countries through the mobilization of private capital.

Clean Development Mechanism (CDM) and Joint Implementation (JI) are flexible mechanisms under the Kyoto Protocol, and they are regulated under the so-called "Marrakech Accords" of 2001. These mechanisms allow Parties with emission targets under the KP – as well as legal entities authorized by them – to carry out emissions reduction projects in other countries, thereby acquiring carbon credits that can be used to lower their cost of compliance. CDM – which allows doing such projects in developing countries – is subject to a thorough authorization procedure, under the supervision of the Executive Board, and independent UNFCCC body where representatives of both Annex I and non Annex I countries seat.

CDM is a still young but growing market: almost 2,500 projects have been registered to date, resulting in approximately 400 million credits issued to date and an expected pipeline of 1,8 billion up to 2012. The primary market, practically non-existent until 2003, was worth over 9 billion euros in 2008-2009. Whilst discussion is progressing on new international mechanisms to promote emissions reductions (avoided deforestation, sectoral mechanisms), agreement on their design – let alone implementation matters – is still far to come. Hence, there is currently no practical alternative to CDM to promote low carbon investments worldwide, and this is why investors (project developers, European industries with emission constraints under the EU-ETS, large financial players) are still looking at it with interest in spite of both the global economic downturn and the uncertainty on the post-Kyoto framework.

To encourage investments, however, regulatory stability and clarity over the “rules of the game” are paramount for the private sector.

The European Commission is now working on a proposal to introduce qualitative restrictions on the use of credits from project-based mechanisms, and has opened a consultation with stakeholders on the matter. The possibility to limit the use of credits is already enshrined in the EU ETS Directive, and a formal proposal is expected before Cancun.

The initiative stems from allegations of “gaming” and lack of environmental integrity of some CDM project types – namely industrial gases, and in particular HFC-23 destruction projects – which have been brought forward by several NGOs. These allegations are now being thoroughly examined by the CDM Executive Board, which has requested detailed information from project participants and is evaluating whether the HFC methodology requires further review, and whether pending issuances are prone to the risk of fraud, malfeasance or incompetence on the part of DOEs (Designated Operational Entities, i.e. the certifiers of CDM credits).

In this sense, Enel-Endesa believe it is critical to trust the system and the procedures of the UNFCCC and CDM (where EU and Member States play a very significant role) in order to ensure the integrity and credibility of this mechanism. Hence, the European Commission should, as a minimum, wait for the conclusions of the EB investigation before labelling any project type as non-eligible under EU-ETS.

Environmental integrity of HFC-23 projects: where is the issue?

We would first like to recall some key facts about the projects now under the spotlight, which have been largely overlooked in the recent debate:

- HFC-23, a by-product of HCFC-22 production (a chemical used for refrigeration and air-conditioning), is a very powerful greenhouse gas: its global warming potential is almost 12,000 times higher than CO_2. Emissions reductions achieved to date from these CDM projects amount to approximately 220 Mt, roughly equivalent to total emissions of Netherlands in one year;
- Although HCFC-22 production is regulated under the Montreal Protocol, this only envisages a gradual phase-out of the chemical starting from 2015 in developing countries. As a consequence, HFC-23 emissions are largely unregulated in

developing countries, as there is no international or national regulation mandating destruction of this gas. Therefore, CDM is currently the only tool preventing the release into the atmosphere of GHG emissions from HCFC-22 production sites;

- HFC-23 projects have played a pioneering role in the CDM. In a context of very high transaction costs and operational and regulatory uncertainty, HFC-23 projects - due to their high reduction potential per project and high operational reliability - were the early-mover choice, and that is why they account for a large share of credits issued to date. HFC-23 projects helped structure the CDM process and turn Kyoto flexible mechanisms into reality, paving the way to small-scale projects, renewables, energy efficiency, etc.

CDM has been accused of providing a perverse incentive to increase HCFC-22 production in developing countries. However, there is no evidence of this: demand for products with HCFC-22 in China and India has grown significantly in recent years, but CDM sites meet less than half of today's demand. Moreover, potential distortions have been addressed long ago by CDM methodologies: only plants existing before 2002 were deemed eligible under CDM, and eligible production is based on historical levels.

Other concerns over industrial gas projects

Besides environmental integrity concerns, other arguments are brought forward by critics of HFC-23 projects. These arguments are not only misplaced – environmental integrity should be the main concern about CDM – but also ill-funded:

- Industrial gas projects allegedly favour a huge money transfer to China and India, which would have excessively benefited from the CDM, compared to poorer developing countries. Hence the need to rebalance the geographical scope of CDM towards Least Developed Countries. However, it should be noted that the Chinese and Indian share of CDM merely reflects their share of emissions from the developing world (i.e. almost 2/3rds of non Annex I countries emissions). On the other hand, all LDCs combined account for barely 1% of non Annex I countries emissions. Whilst promoting projects in these countries is desirable, CDM flows towards China are justified by the objective to curb global emissions where it is most effective, and to involve developing countries in mitigation actions. In fact, China is now even looking at CDM experience to start a domestic "cap & trade" programme.

- These projects are also accused of making huge profits due to very low abatement costs. However, this argument goes against the core principle of having a carbon market, where investors will naturally have an incentive to look for “low-hanging fruits”: the ultimate purpose of cap & trade is to reduce emissions in the most cost-efficient way, thereby lowering compliance costs. Additionally, it should be noted that in China – a major host of HFC projects – 65% of CER revenues are taxed by government and reinvested in climate change activities, further enhancing sustainable benefits resulting from these projects.
- Industrial gas projects supposedly prevent demand for new crediting mechanisms, such as sectoral schemes. Enel-Endesa have repeatedly highlighted the support for new schemes that would enhance carbon markets and provide a broader framework to attract private capital into climate finance. However, as noted above, agreement on these mechanisms has not been reached yet (and we do not believe that unilateral restrictions on CDM will facilitate the negotiation with EU counterparts). In any case, experience with CDM shows that several years are needed for designing and implementing these schemes, even after an agreement is reached. Therefore, the idea that these schemes would be able to fill the gaps of a ban on some CDM projects is unrealistic. Moreover, if there is a consensus on new schemes, it shall take place within the context of a global international agreement, envisaging more ambitious targets, including an enhanced use of flexibility mechanisms, allowing room for both CDM and new credits.

Introducing Qualitative Restrictions in the ETS and its impact on CDM development

In light of the above, we do not believe that quality restrictions are needed. If the EC pushes forward a proposal on qualitative restrictions, it must clarify the objectives and the principles driving the decision to ban certain project types.

In this context, introduction of qualitative restrictions on the use of credits in the EU-ETS should avoid disruptive effects on a market which is already vulnerable. To this end, restrictions should be based on these principles:

- objective criteria;
- exhaustive definition;

- no retroactive application;
- widespread consultation with all relevant stakeholders.

If these principles are not applied, the unintended consequences could be the following:

- Market distortions: a credit supply gap could arise, in a moment in which no other alternative mechanism is yet in place or mature enough, leading to a potential increase in cost for compliance players. Also, market fragmentation (due to different values of CER classes) could hamper liquidity.
- Discouragement of future investments. Qualitative restrictions would set a very dangerous precedent for market players. Already it is being reported in the news that other project types besides HFC-23 are being targeted by the same kind of allegations. In this context, increased perception of risk related to new projects would make them unsustainable (especially if restrictions are based on simple allegations and not on thorough scientific review).
- Undermining trust in the international process. As mentioned, the CDM EB has already undertaken action to address concerns on HFC-23. Unilateral actions on the part of EU could inadvertently slow down progress on a comprehensive climate agreement and on new crediting mechanisms, which is against EU's interests.

Proposal

Taking into account the concerns above, if the Commission does pursue the idea of enforcing quality restrictions, it should bear in mind that operators took commitments in the CDM market with a long-term perspective, relying on the fact that the EU-ETS would last beyond the Kyoto compliance period. Therefore, we believe it should limit the restrictions to new projects, and to already registered projects after expiry of the first crediting period (most industrial gases projects' first crediting period expire by 2014 at the latest; if renewed, however, they could issue credits to 2020 and beyond). Obviously, the restrictions should be based on when the emissions reductions are achieved, and not when the credits are issued, as operators should not be penalized for delays in CER issuance process.

This would approximately halve (by 800 Mt) the credit pipeline from these projects to 2020, freeing up significant demand volumes, consistently with EC's priority to encourage certain types/technologies of offset projects, and to promote geographical diversification of CDM. This approach is roughly in line with applying the maximum notice period envisaged under

art. 11a, para. 9 of Directive 2009/29/EC before enforcing the restrictions (i.e. 3 years from their adoption).

At the same time, it would:

- be compatible with the CDM process;
- safeguard investors' vested rights and legitimate expectations, and avoid legal and contractual problems;
- give enough time to work on the design of new crediting mechanisms, bridging the gap that would otherwise arise in case of abrupt application of qualitative restrictions.

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