

**Submission to the European Commission on Quality Restriction Proposals
in the ETS.
Environmental Investigation Agency (EIA)**

About EIA

The Environmental Investigation Agency (EIA) is a UK-based international non-governmental campaigning organisation committed to bringing about change that protects the natural world from environmental crime and abuse. EIA plays a unique role, undertaking in-depth investigations and documenting the activities of those responsible for the destruction of our natural environment and the loss of biodiversity. By identifying gaps in policy and enforcement and offering intelligent solutions, we seek positive change both in the UK and around the world.

For many years we have supported efforts in the Montreal Protocol to phase out industrial gases that, when released, deplete the ozone layer and act as powerful global warming agents. Our worldwide undercover investigations of the lucrative illegal trade in chlorofluorocarbons (CFCs) – used in refrigerants and banned under the 1987 Montreal Protocol treaty – have helped to close down much of this underground trade. Our pioneering work has received recognition and awards from many quarters, including the U.S. Environmental Protection Agency and the United Nations Environment Program (UNEP).

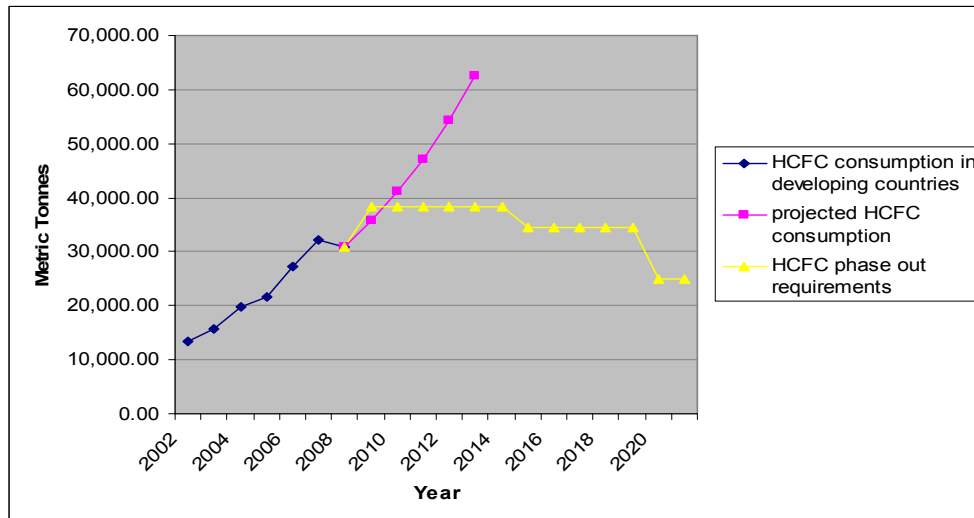
We are aware that you have already received information regarding EIA’s view on quality restrictions in the ETS via policy briefings and presentations. There are, however, some key points we feel are important to raise at this stage. HFC-23 credits are not only unsustainable and subject to allegations of fraud; they also create market distortion and work against the goals of both the United Nations Framework Convention on Climate Change (UNFCCC) and the Montreal Protocol on Ozone Depleting Substances. In order to restore the integrity of Europe’s carbon markets and to address these serious allegations, Europe must act now to immediately ban HFC-23 credits from the EU ETS.

The Clean Development Mechanism’s HFC-23 destruction projects work in contravention to the goals of the Montreal Protocol on Ozone Depleting Substances

In 2007 Parties to the Montreal Protocol agreed to accelerate the phase-out of HCFCs. For developing countries this means freezing production and consumption in 2013 at the average of 2009-2010 levels, reduce HCFC production and consumption by 10% in 2015, 35% in 2020 and a total phase-out by 2030.

Recent data from the Ozone Secretariat shown in figure 1. demonstrate the challenging nature of the phase-out. HCFC consumption in developing countries, plotted in dark blue, has grown steadily at 15% per annum. The pink line projects HCFC consumption based on this growth rate and the yellow line marks HCFC phase-out requirements.

Figure 1. HCFC consumption phase-out in developing countries



The challenge is clear, and as the largest contributor to the Montreal Protocol's Multilateral Fund, the EU will have to fund a large proportion of the phase-out.

As the same time, the CDM is creating extraordinarily large profits for HCFC producers in developing countries, further encouraging the rampant growth in HCFC-22 production. For example, in the case of Gujarat Fluorochemicals, India (Project number 0001), their website states that in 2007, CDM revenues from 6.5 million CERs (Certified Emission Reductions) equated to approximately €66 million. We have calculated that this equates to 88% of their pre-tax profits.¹ Furthermore they projected sales of CERs to increase to 8.2 million during 2009. Another Indian company, SRF Ltd, India (number 0115) is reported to have generated approximately €56 million in 2008 from CER sales, accounting for 66% of sales revenue from their fluorochemical business.² Similarly large profits have been reported by Chinese chemical companies under the CDM scheme, despite the fact that 65% of their revenue from CER sales is given directly to the Chinese government.

These enormous cash flows have several consequences: in addition to issues associated with perverse incentives (documented in the Methodology Revision Request submitted to the CDM Executive Board in March 2010) the profits drive down the market cost of HCFC-22. This is encouraging a state of dependency upon cheap and plentiful HCFC-22 in developing countries and impeding the switch to alternatives. The wide availability of cheap HCFC-22 is also increasing the threat of illegal trade in these chemicals as the phase-out begins to take hold.

How HFC-23 creates market distortions and works against UNFCCC goals

As demonstrated above the CDM has given HCFC producers in developing countries the ability to produce HCFC-22 at far lower costs than their European counterparts. As a result European fluorochemical producers no longer produce HCFC-22 for refrigerant purposes, despite there being allowances in EU laws for such production.

This market distortion is likely to impact developing country production of the next generation of fluorochemicals, HFCs. For example, SRF began receiving CDM finance in 2004 and two years later began HFC production with an investment of approximately €13.5 million.³ It is now producing HFC-404a and HFC-134a. This means that the EU ETS (as the chief user of CERs from HFC-23 CDM projects) is financing the growth in production of a gas controlled by the Kyoto Protocol, in direct opposition to the goal of the UNFCCC.

The profits to be made from HFC-23 CDM projects are also an obstacle in current international moves to address other HFCs under the Montreal Protocol. Two proposals have been put forward to enable a step by step phase-down in consumption and production of HFCs under the Montreal Protocol, but strong opposition to these proposals is being led by China and India, the two countries that profit the most from the HFC-23 projects.

EIA is greatly concerned that the CDM projects are not only working against potentially massive climate gains to be made through an HFC phase-down under the Montreal Protocol, but that only half of developing HFC-23 production is actually being abated under the CDM projects. A proposal to cost effectively address HFC-23 in facilities outside the CDM has also been put forward to the Montreal Protocol Meeting of the Parties in November this year.

¹ GFL Profit information from CDM was obtained here
<http://www.gfl.co.in/news%20clipping%20-%20dalal%20street%20journal%20-%20analysis%20-%20cdm%20business%20-%20july%2023-aug%205,%2007%20-%2025072007.pdf>
pre tax profits obtained here

<http://www.gfl.co.in/Annual%20Reports/GFL%20Annual%20Report%202007-08.pdf>

² http://www.srf.com/inv/Annual_Report_2008-09.pdf

³ http://www.srf.com/inv/CB_Sustainability_Report_2006-07.pdf

Why act in Phase II?

The 19 registered CDM HFC-23 destruction projects are expected to generate 478 million CERs by 2012.⁴ In 2008 and 2009 a total of 97 million HFC-23 CERs were surrendered into the ETS for compliance.⁵ This leaves a possible 381 million CERs that could be surrendered in the remainder of Phase II. A recent analysis by Sandbag suggests that, due to over allocation and economic slowdown at the end of Phase II, the market will be long by 579 million credits.⁶ Banning HFC-23 in Phase II will not only help rebalance the market in terms of current over-allocation but it will address the enormous number of un-surrendered HFC-23 credits within the system that currently undermine and threaten the integrity of the ETS.

EIA discussions with carbon exchanges, banks and project investors have all confirm that the market would indeed be able to adapt to the loss of HFC-23 credits in the rest of Phase II. In fact the halting of credit issuance in the summer by the UNFCCC's Executive Board has already prepared the market for such a move.

Economic impact of restricting HFC-23 in Phase II

EIA believes the largest economic impact of restricting HFC-23 credits in Phase II would fall on the companies involved in HFC-23 destruction projects as they would not receive income as forecast. We see this as a desirable outcome as it would stop the perverse incentives to produce HFC-23 at higher than necessary ratios and it would end the subsidisation of HCFC-22 production. With the capital costs of HFC-23 destruction technology already paid, a relatively small amount of finance is required to continue to ensure HCFC-22 facilities continue to destroy HFC-23 rather than release it to the atmosphere.

Many HFC-23 credits have been purchased via contracts which are not paid until the CERs are delivered, European buyers would have to find alternative sources of credits. This may mean purchasing CERs at higher prices than the HFC-23 contract prices, however it will also give a much needed boost to other more sustainable projects which actually represent real emission reductions and will help prepare carbon markets for the future. Given the long nature of the market predicted at the end of Phase II it seems unlikely that a ban on HFC-23 credits will affect the carbon price dramatically.

Why banning HFC-23 in Phase III alone isn't enough

Waiting to act until Phase III would be an ineffective 'token' measure as the impact on the supply of CERs will be minimal. Almost 60% of HFC-23 projects will be up for renewal of their crediting period during late 2013 to early 2014. Many carbon market analysts and investors have indicated that further investment in HFC-23 projects is unlikely due to the problems associated with the projects and the general move away from large-scale projects that generate windfall profits while doing nothing to enhance sustainable development. The majority of HFC-23 credits will be issued in Phase II, and if the commission is serious about addressing environmental integrity in the EU ETS it should act now.

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⁴ UNEP Risoe Centre www.cdmpipeline.org

⁵ Data derived from Sandbag.org, original data source (community independent transaction log) CITL.

⁶ Sandbag (2010) "Cap or Trap: How the EU ETS risks locking in carbon emissions"