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Memorandum

to the

Energy and Climate Change Committee

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on

The EU Emissions Trading System: New Inquiry

Submitted by FERN

Executive Summary

I. Fundamental flaws in the design of the EU ETS have been exposed by (a) a series of fraud and cybercrime incidents; (b) the excessive use of carbon offsets by companies hoarding higher-value EU ETS permits received free of charge; and (c) the lack of a functioning regulatory possibility to adjust the supply of EU ETS emission permits to a sharp economic downturn, and the resulting drop in emissions far below projected levels that were used to calculate permit allocation. It appears unlikely that amending the regulatory framework of the scheme with the aim of addressing these shortcomings will succeed when the challenge is not to remedy minor design flaws or to 'iron out the teething problems' but where the failures have exposed structural flaws of the design itself. Attempts at scaling up project-based offsets to

sectoral offset trading schemes and expanding carbon trading schemes to additional sectors, such as the forest and land use sector (where error margins are even bigger and risk of reversal of carbon savings is significant), or linking trading schemes that operate in jurisdictions where enforcement capacity differs significantly, will provide the ground for trading in 'subprime' carbon derivatives. This is likely in particular because much of the trading activity in carbon offsets is carried out 'over-the-counter' and where the spot trading of carbon permits remains largely unregulated.

II. Regulatory arbitrage and use of loopholes by fraudsters is already an issue even within the relatively uniform regulatory framework of the EU ETS. For example, in November 2010, a surge in "suspicious" trading activity on the Italian GME exchange (where volumes on the spot market exceeded those on the futures market, and carbon traded at a discount for weeks) seemed to be the result of carbon market fraudsters switching their activities from Denmark, then Spain to Italy, one of the few countries that at the time had not yet implemented 'reverse-charge' for VAT. At least one EU Member State – Estonia - has still not introduced reverse VAT charges for carbon trades and has indicated it will only do so once another incident of fraud provides evidence for the need to introduce reverse charging.

Co-ordination among the EU Member States has also shown to be a challenge in relation to an earlier VAT scandal, with the Danish EU ETS register at the heart of the fraud; reportedly France and Germany refused to give Danish authorities, who were pursuing VAT carbon fraud, access to trading accounts on grounds of data protection. The handling of the incident of theft of EU ETS permits straight out of account holder registries in early 2011 further exposed the vulnerability of the EU ETS design and the consequences of its splintered responsibility between European Commission and Member States. Due to differences in Member States' legal systems the legal wrangling over who holds ownership over the stolen permits is expected to continue for several years.

The risk of regulatory arbitrage and fraud, difficulties of co-ordination across jurisdictional boundaries and legal conflicts will increase significantly with the linking of separate regional carbon trading schemes to the EU ETS. The stringency of the caps in the different regional schemes will vary, as will the rules on which types of carbon offsets can be used in the scheme, or how many offsets are permitted. All these differences will provide significant potential for regulatory arbitrage, malpractice and fraud which would further

reduce the likelihood of carbon trading schemes contributing to climate change mitigation.

IIIIII. UN-backed carbon offsets are an integral part of the EU ETS, their entry into the scheme is regulated through the Linking Directive and subsequent regulation. 'Offset' credit creation however, is based on conceptual incoherence, is characterized by measurement and accounting problems that are unsolvable and is giving rise to significant property rights conflicts. Yet, all existing and planned carbon trading schemes include the option to use carbon offsets. Were the EU ETS to link with offset trading schemes based on projected business-as-usual sectoral baselines, the flaws of CDM-type project-based offsets would merely be scaled up to the sectoral level. The impossibility to verify 'additionality' and the likelihood for non-additional sectoral offset credits entering the trading scheme would remain just as with project-based offsets – only on a larger scale.

IVIV. Continuation of the EU ETS beyond 2020 may thus not only fail to contribute to the EU achieving its objective to limit global warming to an average of 2 degrees C but also continue to undermine tried and tested direct regulatory approaches such as feed-in tariffs, benchmarking, aggressive energy efficiency programmes coupled with strategic investments in 'smart grids' and investments in initiatives to reduce the EU's carbon footprint outside the EU.

Introduction

FERN welcomes the Energy and Climate Change Committee's new inquiry into the EU Emissions Trading System. We are grateful for the opportunity to comment on the issues in the inquiry's remit.

1. FERN is a European non-governmental organization. We work to achieve greater environmental and social justice in the policies and practises of the European Union, with a focus of FERN's work on forests and forest peoples' rights.

2. FERN has pursued research into climate policies and carbon trading for over ten years¹. Our research and advocacy has been carried out in close collaboration with organisations in the Global South and NGO networks. FERN has provided submissions and discussion papers, including to previous Environmental Audit Committee inquiries into carbon markets and the EU Emissions Trading Scheme. Most recently, FERN provided submissions to the CFTC on financial markets regulation as it relates to fraud and malpractice in carbon markets and to the UNFCCC on 'New Market Based Mechanisms'.

1 For a summary of the analysis and extensive case study references, see 'Trading Carbon. How it works and why it's controversial. www.fern.org/tradingcarbon

Specific comments on the issues in the inquiry's remit

Does the EU ETS remain a viable instrument for climate change mitigation in the EU?

3. It is worth recalling that it is only the cap in carbon 'cap-and-trade' schemes that determines the climate effectiveness of the scheme; the trade only functions as a cost-management tool. In the case of the EU ETS, the cap is so oversized as to render the scheme's contribution to climate change mitigation negligible²³. Due to the significant overallocation of free allowances to most covered installations in Phases 1 and 2 of the EU ETS, it is questionable whether the scheme can be considered to have contributed to any significant climate mitigation by 2020⁴. Phase 2 of the scheme further allows the carry-over of unused permits into Phase 3. This banking of unused permits, combined with the lack of a mechanism to revise the baseline in light of the sharply reduced emissions due to the economic downturn has led to a significant collective surplus of permits held by covered entities that may increase to 1.9 billion tonnes through to 2020 - the equivalent of a year's worth of carbon permits.^{5 6}

4. Proponents of the EU ETS argue that the scheme has led to emissions reductions in the facilities covered⁷. These reductions – where they are not merely the result of the post 2008-economic downturn – appear to have been the result of 'low-hanging-fruit' efficiency improvements rather than transformational investments – investments that would contribute to transforming the EU economy into a low-carbon economy which by 2050 will

2 'Buckle Up' Sandbag. July 2011 <http://www.sandbag.org.uk/reports>; Carbon Fat Cats 2011. Sandbag. <http://www.sandbag.org.uk/reports/>

3 The EU Emission Trading Scheme: designed by committee. Arnold Mulder. http://www.europeanenergyreview.eu/site/pagina.php?id_mailing=172&toegang=1ff8a7b5dc7a7d1f0ed65aaa29c04b1e&id=2914

4 EU ETS emissions up 3% in 2010: analysts. Carbon Market Daily. Point Carbon. 25 February 2011. www.pointcarbon.com

5 <http://www.corporateeurope.org/climate-and-energy/content/2011/04/eu-ets-failing-third-attempt>

6 Under Pressure'. Robin Lancaster in: Trading Carbon. July / August 2011. www.pointcarbon.com

7 Carbon Pricing for Low Carbon Investment. Climate Policy Initiative. 2011 <http://www.climatepolicyinitiative.org/files/attachments/88.pdf>

produce 80-90% fewer emissions than today without just increasing its carbon footprint outside the EU.

5. Often, the increase in trading volume is cited as evidence that the EU ETS is working. Where trading is dominated by entities not covered by emissions targets however, an increase in the volume of traded carbon permits and credits does not contribute to climate mitigation: The permits and carbon offsets get traded in secondary markets but this does not lead to additional emission reductions, nor does this form of trading in the secondary markets make significantly more capital available for implementation of emission mitigation activities. Just like profits made in the used automobile market do not result in more profits for car manufacturers, it must not be assumed that profits from trading in a multi-billion dollar carbon market will be invested in climate mitigation. For example, the reality in the carbon market is that the primary CDM market comprises only a small proportion, about 1.5 per cent of the total value of the global carbon market. Thus, only a tiny percentage of the carbon market revenue goes to climate mitigation activity that supposedly resulted in additional greenhouse gas reductions in developing countries⁸.

6. Architects of the EU ETS appear to have underestimated the consequences of the two groups of actors in the scheme having diametrically opposed objectives regarding price development: While entities covered by the EU ETS look to the trading scheme to deliver a predictable carbon price which allows the entities to hedge their exposure and base long-term energy infrastructure investment decisions on the carbon price, the primary objective of most non-compliance actors is the generation of price volatility⁹. These actors not covered by emissions targets prefer price volatility over price predictability because their profit is dependent on volatility. An increasing price volatility from speculation however may well render carbon trading increasingly unsuitable as a cost-management tool for companies with emission reduction obligations. Thus, increased involvement of speculative actors whose primary interest is not the cost-effective implementation of greenhouse gas emission reduction targets may undermine the carbon market achieving its original objective. Participants whose trading is motivated by speculation will use their trading power to generate, exploit and profit from price volatility, as unpredictable price movements is how speculators profit.

⁸ World Bank Carbon Finance Unit (2010): State and Trends of the Carbon Market 2010.

http://siteresources.worldbank.org/INTCARBONFINANCE/Resources/State_and_Trends_of_the_Carbon_Market_2010_low_res.pdf

⁹ EU ETS needs regulator to provide liquidity: Barclays. Carbon Market Daily. 25 June 2010 www.pointcarbon.com

What reduction in emissions will the EU ETS deliver in Phase III, within the EU and abroad?

7. Due to the build-up of a substantial surplus of carbon permits in the EU ETS, the prolonged economic downturn resulting in lower emissions and generous access to carbon offset credits, the high-emitting industry sectors covered by the EU ETS do - in net terms - not need to take domestic action to reduce their emissions before 2017, 12 years after the start of the EU ETS¹⁰.

8. The 1.6 billion tonnes worth of carbon offset credits the companies covered by the scheme are allowed to use in particular call into question whether the EU ETS can be considered to deliver emission reductions. Many companies covered by the EUETS have made extensive use of the ability to use carbon offsets even when they are in possession of large amounts of unused carbon permits. By hoarding higher-value EU ETS permits received free of charge and using cheaper offset credits to cover their emissions, companies have been able to generate windfall profits where the costs of compliance with the EU ETS were calculated using the market value of EU ETS permits and to increase the asset value on their balance sheets by retaining the higher-value permits – assets received free of charge at the time of creation of the EU ETS – on the balance sheet for longer. This substitution of permits with offsets is even more troubling considering that “[c]arbon offsets by definition do not exist in any tangible form. An offset can neither be measured directly nor observed in reality, because it represents the absence of a certain quantity of emissions that would have been emitted under a counterfactual 'without-project' or baseline scenario.”¹¹

In addition, so far during the second phase of the scheme, over three-quarters of these have come from a few industrial gas projects, which are widely considered to lack environmental integrity and exemplify how carbon offsets are far from a cost-effective mechanism for reducing ghg emissions.^{12, 13, 14}

10 See among others, Buckle Up. Sandbag. June 2011. <http://www.sandbag.org.uk/reports>

11 Constructing carbon offsets: The obstacles to quantifying emission reductions. A. Millard-Ball & L. ortolano. Energy Policy 38 (2010): 533 - 546

12 HFC-23 OFFSETS. IN THE CONTEXT OF THE EU EMISSIONS TRADING SCHEME. Policy Briefing EIA & CDM Watch. JULY 2010

13 Chinese firms cashing in on EU carbon trade. Carbon Market Daily. 16 July 2010. www.pointcarbon.com

14 CDM fails to cut HFC-23 emissions. Carbon Market Daily. 20 April 2010. www.pointcarbon.com

9. With regards to emission reductions delivered abroad, it is important to recall that (1) each supposedly additional emission reduction abroad is neutralised by an additional emission reduction within the EU ETS that allows the company using the offset credit to release emissions over and above the cap set by the EU ETS. There thus is at best no increase in emissions but never a net emission reduction as a result of an offset 'reduction'; (2) it is impossible to know with certainty whether any given offset credit claimed is additional because 'additionality' is based on projections of emissions that would have occurred in the absence of the offset project – calculations which are necessarily hypothetical. As a result, use of carbon offset credits by companies subject to binding emissions limits may in fact increase, not reduce global emission reductions if the offset credits are not generated through a genuinely additional emissions reduction that would not have occurred in the absence of the offset project.¹⁵

Could the environmental and economic efficiency of the EU ETS be improved by linking with other emissions trading schemes and how can this be achieved

10. It is very unlikely that the efficiency of the EU ETS could be improved by linking with other carbon emissions trading schemes, not least because of the complexity of the regulatory regimes required for these trading schemes¹⁶. Establishing and implementing the EU ETS for example requires a vast array of regulation: The 2008 revision of the EU ETS will require 14 comitology¹⁷ procedures, seven legal proposals and many other points to review and monitor before the directive is fully in force. "It is so vast that it is overwhelming," according to one official.¹⁸ Negotiating and writing these regulations, rules and guidelines is also extremely time-consuming – the

¹⁵ CDM Auditors Flunking Additionality. Patrick McCully. International Rivers. 2009.

<http://www.internationalrivers.org/en/node/4412>

¹⁶ "If training or technical assistance is required to comprehend a new market mechanism, it is probably too complex to achieve its intended goals." Frank Ackerman in: The Economics of Collapsing Markets *real-world economics review*, issue no. 48, 2008

¹⁷ The term comitology refers to the institutional process by which the European Commission and EU Member States negotiate implementing legislation once a law has been passed which requires further specification for implementation.

¹⁸ J. Rankin (2009): A winding path to lower emissions. <http://www.europeanvoice.com/article/imported/a-winding-path-to-lower-emissions-/63930.aspx>

European Commission's internal timetable on the EU ETS comitology shows a to-do list that extends out to the 2020 work programme.¹⁹ Further regulation will now be required to fill the gaps in regulatory detail which have been revealed by the recent incidents of theft of EU ETS permits straight out of permit-holders' accounts:²⁰ Legal wrangling is expected to take years before it can be established who holds the rights to the stolen permits - those who had them stolen despite 'storing' them in accordance with the rules of the scheme or those who bought them in good faith, having followed appropriate due diligence?²¹ The stolen permits had in many cases been traded on several times traded between traders in different jurisdictions before trading was halted.

11. In jurisdictions where monitoring and enforcement capacity is far less developed than in the EU, establishing and maintaining such capacity will require substantial resources. It is unlikely that costs to build up and maintain such monitoring and enforcement capacity would be born by market participants. Where the host country of the linked scheme also does not have or provide the resources to establish and maintain such functioning monitoring and enforcement structure, the risk from lax enforcement will affect all schemes that are linked.

12. Regulatory arbitrage is already a problem even in the relatively uniform regulatory framework and enforcement environment of the EU ETS. For example, in November 2010, a surge in "suspicious" trading activity on the Italian GME exchange (where volumes on the spot market exceeded those on the futures market, and carbon traded at a discount for weeks) seemed to be the result of fraudsters switching their activities from Denmark, then Spain to Italy, one of the few countries that at the time had not yet implemented 'reverse-charge' for VAT. At least one EU Member State – Estonia - has still not introduced reverse VAT charges for carbon trades and has indicated it will only do so once another incident of fraud provides evidence for the need to introduce reverse charging²².

13. Linking may further reduce the already questionable effectiveness of the EU ETS because it will also increase complexity even further and raise the

19 Ibid.

20 Point Carbon (2011): EU spot carbon market re-opens, buyers wary. 04 February 2011. www.pointcarbon.com

21 Lawyers prepare suits over stolen EUAs. Carbon Market Europe. 15 April 2011. www.pointcarbon.com

22 Estonia snubs EU on carbon VAT fraud push. Carbon Market Daily. Point carbon 29 July 2011. www.pointcarbon.com

risk of ‘regulatory arbitrage’²³ and fraudulent trading. The particular design of the schemes the EU ETS might link to would almost certainly have to cater to national priorities and particularities, just like the EU ETS does and did in the initial allocation of free permits. Such accommodation of national particularities would almost inevitably create the possibility for regulatory arbitrage when different national or regional trading schemes are linked²⁴.

14. Carbon trading schemes that are open to non-compliance actors and which allow trading across different jurisdictions will provide loopholes that will be easy to exploit and difficult, if not impossible to effectively regulate. Architects of the EU ETS underestimated the attraction that such open trading schemes will pose to fraudsters and organized crime. They further failed to foresee that in order to prevent fraud, rigorous design and due diligence *before* actors are allowed to open trading accounts, is essential. The EU ETS has already seen a number of incidents of fraudulent trading, in three cases causing spot trading bourses to close trading activity for day(s)²⁵. These incidents suggest that the architects of the EU ETS appear to have underestimated the importance of the design on the functioning of the trading scheme – and that in fact subsequent amendments will not be able to remedy the flaws of poor design. Linked trading schemes spanning countries with significantly different potential and cultures to regulate and monitor linked carbon trading schemes will increase such risk for fraud and malpractise exponentially.

15. Linking of carbon trading schemes will most likely also increase the predominance of speculative trading in the carbon market, thus further calling into question the usefulness of carbon trading as a cost-management tool: “We’ll have a financial crisis in emissions at some point. There’ll be derivatives and all these unemployed investment bankers will then go work

23 When regional carbon markets are linked, the carbon allowances from the different markets will be considered equivalent and fungible. If the stringency of the targets is not comparable or enforcement and monitoring capacity and scrutiny vary, different prices will develop in different parts of the market for the same product – a carbon allowance. Traders will then be able to use these regulatory differences to generate profit by buying where the permits are cheap and selling for a profit but below the price level in the linked carbon market where regulation and scrutiny are more stringent. The result would be a market scheme dominated by the lowest common denominator.

24 A Changed Emissions Landscape Affects Planned Role for Cap-and-Trade. Legislative Analyst's Office. 29 June 2011. Presented to the California Senate Select Committee on the Environment, the Economy, and Climate Change.

25 Carbon Market Europe (2011): Registries remain closed as traders nurse legal headaches. Point Carbon 11 February 2011. www.pointcarbon.com; Point Carbon: Italian trader takes EC to court over stolen EUAs. 14 Feb 2011 www.pointcarbon.com

on carbon trading and come up with products which will lead to a crisis. ... You'll find few economists who disagree.”²⁶

Could sectoral agreements form part of the future of the EU ETS?

16. Scaling up the CDM's project-based approach to a sectoral or programmatic offset approach will not remedy the fundamental flaw at the heart of offset mechanisms: the reliance on hypothetical baselines for the calculation of offset credit volumes. In the words of the US Government Accountability Office, “Because additionality is based on projections of what would have occurred in the absence of the CDM, which are necessarily hypothetical, it is impossible to know with certainty whether any given project is additional.”²⁷ The same will be true for sectoral and programmatic offset schemes that equally rely on hypothetical baselines for the calculation of offset credit volumes. In fact, the danger of significant overestimation of volumes of offset credits that will be considered additional will increase when the use of hypothetical baselines is extended from the project to the level of whole programmes or sectors.

17. The land use and forest sector are particularly ill-suited for a trading-based market mechanism. In addition to this submission's view that sectoral offset trading schemes will not remedy the flaws of project-based offsets, any offset trading mechanism would be particularly ill-suited to attempting to reduce emissions in the land use and forest sector. Error margins in quantification make Monitoring, Reporting and Verifying (MRV) of carbon fluxes ‘with sufficient accuracy’ impossible to achieve in forests and agriculture for the time being and possibly for the expected duration of the carbon market²⁸.

²⁶ Kenneth Rogoff, Harvard, former IMF Chief Economist, cited in: Rebecca Weisser: Tax carbon rather than trade in it. <http://www.theaustralian.com.au/news/opinion/tax-carbon-rather-than-trade-in-it/story-e6fgr6zo-1225787724278> 17 October 2009

²⁷ Testimony of John Stephenson, Director of Natural Resources & Environment, Government Accountability Office, before the Subcommittee on Energy and Environment, Committee on Energy and Commerce, House of Representatives, March 5, 2009 at <http://www.gao.gov/new.items/d09456t.pdf>

²⁸ REDD and Forest Carbon. Market-Based Critique and Recommendations. The Munden Project. March 2011. www.mundenproject.com

Will the EU ETS be able to access viable alternatives to international credits without the Clean Development Mechanism?

18. In the context of binding emissions limits, offsets do not contribute to emissions reduction because the claimed reduction in one place allows emissions in excess of a binding cap in another location outside the capped sector. The best-case scenario is thus no net increase in emissions, but never a reduction. From a climate mitigation perspective, and given the drastic cuts in emissions that need to be achieved if runaway climate change is to be averted, discontinuing the use of offsets in the carbon compliance market would thus be a positive and desirable contribution to climate mitigation: “The CDM is not a real reduction, it is an offset of an emission and so we will need to move away from the CDM that’s clear.”²⁹

How serious an impact have the recent cases of fraud had on confidence in the EU ETS? Are further improvements in security and auditing required?

19. The string of fraud incidents and the way these have been handled by the regulatory authorities of the EU ETS have shaken the confidence in the EU ETS^{30 31 32 33 34}. The combination of these incidents of fraud, remaining regulatory uncertainty over liabilities and the collapse in carbon prices due to overallocation have led to an exodus of carbon traders and financials from the carbon market.

29 Robert Dornau, SGS quoted in: Which way to turn? Robin Lancaster. Trading Carbon Vol 03 Issue 02 March 2009 Special Report ‘Clean Development Mechanism’.

30 Draining confidence in ETS helps send carbon into freefall. Carbon Market Europe. 24 June 2011. www.pointcarbon.com

31 Under pressure. Is the European Commission up to the task of running the EU emissions trading scheme. Trading Carbon. July / August 2011. www.pointcarbon.com

32 EUR 5 billion and counting. Barclays capital guest article in Trading Carbon March 2011. www.pointcarbon.com

33 ICE maintains zero collateral value for carbon units. 15 June 2011. Carbon Market Daily. www.pointcarbon.com

34 One more crisis will destroy EU carbon market: Barcap. Carbon Market News. 02 March 2011. www.pointcarbon.com

20. Even if security measures had been on par with e.g. online banking industry practice, the EU's decision to create a carbon market in which virtually anyone can open a trading account, creates regulatory challenges which the EU ETS regulator may be unable to resolve^{35 36}. Many participants trading emissions permits and offset credits used in the EU ETS are not covered by financial markets regulation and operate outside the oversight of financial standards authorities. Proposed revisions of financial markets regulation currently underway in the EU include the option to exempt certain activities from the new rules³⁷. Should carbon trading or carbon market participants be exempted from the new regulations, the sector will continue to operate largely unregulated. Yet, even if carbon trading and all carbon market participants will have to comply with new financial markets and derivatives regulation it is questionable if such regulation will be able to remedy the flaws of poor design of the trading scheme.

21. The risks associated with a trading regime as open as the EU ETS are exacerbated further by the elusive, virtual nature of the asset(s)³⁸ being traded. In the world of finance for example, even collateralized mortgage debt obligations (CDOs) were ultimately based on real, specifiable mortgages on actual houses, even if the underlying asset has been sliced, diced, and re-packaged in ways that made it virtually untraceable and unassessable. There ultimately was an end-user who tested the validity of the asset's valuation. A carbon market that includes carbon offsets by contrast lacks such a possibility for testing of the product by the end-user because the commodity is being created on the basis of a hypothetical story – the story of how many emissions would have been emitted had it not been for the offset project. The actual emission levels of the project are then compared with the levels assumed in the hypothetical baseline. The difference between these two emissions figures is the number of offset credits the project can sell as additional emissions savings. The verifiability of these 'additionality' claims

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Ten ways to game the carbon market. Friends of the Earth. 2009 <http://www.foe.org/10-ways-game-carbon-markets>

36 Carbon trading a front for money-laundering: experts. <http://www.hindustantimes.com/Carbon-trading-a-front-for-money-laundering-experts/Article1-573537.aspx>

37 Market seeks 'tailor-made' spot trading rules. Carbon Market Daily. 04 May 2011. www.pointcarbon.com

38 While carbon permits and offset credits are considered fungible and both units can be used for compliance with Kyoto Protocol and EU ETS targets; yet they differ significantly with regard to their creation and the resulting ability to verify. For detail, see Trading Carbon. How it works and why it is controversial. www.fern.org/tradingcarbon

has long been questioned³⁹, and many carbon market proponents today agree that 'there is no one right answer to the question of additionality'⁴⁰. The consequence of this is that many carbon offsets used in the EU ETS are not really backed by genuine additional emission reductions. The only reason why a market that trades fictional offset credits alongside credits based on actual emissions reductions does not collapse is that approval by the UN's CDM Executive Board turns those fictional offset credits into a commodity that is accepted for use in the carbon market that was created by the Kyoto Protocol, and to which the EU ETS is linked via the 'Linking Directive'. No provisions exist in the CDM rulebook for withdrawing or cancelling offset credits that have been issued even if it subsequently became apparent that the savings claimed were not additional. In a step that will further erode the soundness of the asset and increase the risk of fraud and malpractice, CDM Executive Board members have recently stated that they have been "subtly signaling to investors a significant relaxation of that [additionality] rule, specifically for projects in sub-Saharan Africa and other least developed areas"⁴¹ in order to increase the number of offset projects in Least Developed Countries. With this move, the CDM Executive Board has discarded the most fundamental requirement for offset credits that allow additional emissions over and above a legally binding limit to actually be backed by additional reductions. Whether one can effectively regulate and build up confidence in a market based on assets of such dubious nature is doubtful.

22. Ultimately, without an international agreement to keep substantial amounts of the remaining fossil fuel deposits unexploited, preventing temperature increases well beyond 2°C will not be possible. Furthermore, as long as the international focus remains on regulating end use rather than input of fossil fuels at source, the absence of ambitious and binding emission reduction commitments will result in a lack of demand for offset credits from scaled-up trading mechanisms. Finally, multiple cost-effective alternatives to trading approaches abound, both market- and non-market based. Therefore, this submission concludes that terminating the EU ETS by 2020 and

39 See among others, Carbon Trading. A critical conversation about climate change, privatisation and power. L. Lohmann (ed). 2008 www.thecornerhouse.org.uk

40 See among others 'Assessing the additionality of CDM projects: practical experiences and lessons learned.' L. Schneider. Climate Policy 9 (2009): 242-252; Constructing carbon offsets: The obstacles to quantifying emission reductions. A. Millard-Balls & L. Ortolano. Energy policy 38 (2010): 533-546

41 U.N. body relaxes rules to spread clean development credits around. Nathaniel Gronewold, E&E reporter. 25 July 2011. <http://www.eenews.net/search?keyword=CDM&commit=go%21>

replacing it with a combination of tried and tested direct regulatory approaches and non-trading market instruments would provide much higher probability of enable the emission reductions needed to avoid runaway climate change than extending the EU ETS beyond 2020 and / or linking it carbon trading schemes in other jurisdictions. Incidents of fraud and malpractise as recently experienced in relation to trading with EU ETS permits can be expected to continue and grow were the EU ETS to link to carbon trading schemes in other jurisdictions or include additional sectoral offset schemes.

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