



EU ETS Credit Restrictions Prospects for restricting credits from large hydropower projects

- Concerns over the additionality and sustainability of large hydropower projects under the CDM have led to calls for reform, including potential restrictions on credits from such projects under the EU ETS
- The EU Commission has been clear that no such restrictions are currently planned, and that it will await the outcome of the current UNFCCC-level reform dialogue before considering further measures
- Restricting large hydro credits could have a major effect on supply and demand in the EU ETS, potentially providing the Commission an incentive to act where other measures to adjust supply and demand are not forthcoming
- If the Commission does decide to act, a range of options are possible, and which path may be chosen is likely to depend on political and market factors

Recently speculation has arisen in some quarters that the European Commission may be planning to restrict carbon credits generated by large hydropower projects. Large hydropower projects under the CDM¹ have for some time been subject to criticisms concerning their additionality and sustainability. The recent speculation arose partially on foot of an EU-commissioned study on the integrity of the CDM released in December 2011 (the 'CDM Integrity Study'), which included an assessment of options for the EU to restrict the use such credits.²

Under the revised European Union Emission Trading Scheme (EU ETS) Directive the European Commission is empowered to restrict the use of specific offset credits from certain project types for compliance purposes in the post 2012-period. While specific restrictions on credits existed under the previous Directive, the revised version differs in granting the power to introduce restrictions to the Commission, rather than requiring legislative amendments for this purpose. The power granted is framed in general terms, and the Commission has stated that decisions to restrict credits may take into account "project-type, economic, environmental, strategic and administrative circumstances."³ Hence, the Commission's scope for restricting credits is potentially quite broad.

The Commission has broad powers to restrict the use of certain offset credits for compliance purposes under the EU ETS

Up until now the Commission has adopted just one set of restrictions on credits, namely those on industrial gas credits (HFCs and N₂O). The Commission has been careful to dispel the rumours on restricting the use of credits from hydropower plants, stating clearly that no new restrictions are currently planned.⁴ While this indicates that restrictions are not likely to be forthcoming in the near to medium term, it is worth considering what circumstances could lead to the Commission revisiting this stance in the future.

Main criticisms of large hydro projects under the CDM

The main criticisms associated with large hydropower projects are related to the concepts of *additionality* and *sustainability*. Additionality refers to the CDM project

being the direct cause of emission reductions (i.e. they would not have occurred in its absence), while sustainability refers to the contribution of a project to local social, economic and environmental wellbeing. Large hydro projects are often criticised as non-additional as many are arguably economically viable even without carbon finance and often enjoy favourable government policy and support. Issues frequently raised with respect to sustainability include loss of biodiversity, the displacement of local communities and contribution to land use change.

Current measures and moves for reform

Measures to deal with the criticisms outlined above have already been taken at both the UNFCCC level (on the supply side) and at EU level (demand side). The UNFCCC has focused on additionality of CDM projects in general, including the introduction of standardised approaches to baseline and additionality assessment, with less focus on sustainability. Measures at EU level, by contrast, have focused primarily on sustainability concerns. Most notably, the Linking Directive requires Member States to ensure that hydropower projects with a generating capacity exceeding 20 MW respect relevant international criteria and guidelines, including the standards as formulated by the World Commission on Dams (WCD). In order to comply with this requirement Member States adopted voluntary guidelines and templates which seek to harmonise the application of these standards. Concerns exist however over their implementation and therefore the implementation of the Directive's sustainability requirements, leading the European Climate Exchange, the world's leading carbon market exchange to exclude CERs from being traded on its platform.⁵

There is consensus that current measures are insufficient to deal with criticisms concerning additionality and sustainability

In late 2011 the Commission carried out a study to investigate additionality and sustainability of CDM projects. This CDM Integrity Study found there is broad consensus amongst policy makers and other stakeholders that the current measures under the UNFCCC and the EU ETS are not sufficient to ensure additionality and sustainability of large hydropower projects. Given the prevalence of this view and the increasing scrutiny of the CDM from a range of actors, it is reasonable to expect that reforms will be sought in the near to medium term. Indeed, at EU level the very commissioning of the study on CDM integrity and its focus on large hydro projects signals the increased importance of this issue on the Commission's agenda.



The Commission's current position is that it will await the outcome of the recently established High-level Panel on the CDM Policy Dialogue initiated under the UNFCCC before establishing further restrictions – in other words, demand side restrictions are only likely to be introduced if supply-side reform efforts fail (or are expected to fail) to bear fruit.⁶ With the High-level Panel due to release its final report in September 2012, it is likely that there will be little movement for demand-side reform before this date. While the Panel's report itself will not result in reforms, future moves by the EU may depend on the urgency with which the report's recommendations are taken up by Kyoto Parties and the CDM Executive Board.

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Potential demand side measures

A further factor influencing the EU's decisions may be the supply/demand balance in the EU ETS. As shown in figure 1, credits from large hydro projects are expected to constitute the largest share of CERs issued up to 2020 of any single project type. Once the ban on industrial gas credits comes into force, large hydro CERs will constitute an even larger share of credits entering the already over-saturated EU ETS. Given this dominance, a full ban on large hydro credits could serve to eliminate the current over-supply.⁷ In the event that the EU were to move to a 30% commitment or to approve a substantial set-aside of emission units however, the supply-demand balance would change radically, making a move to ban large hydro credits less desirable from this perspective.

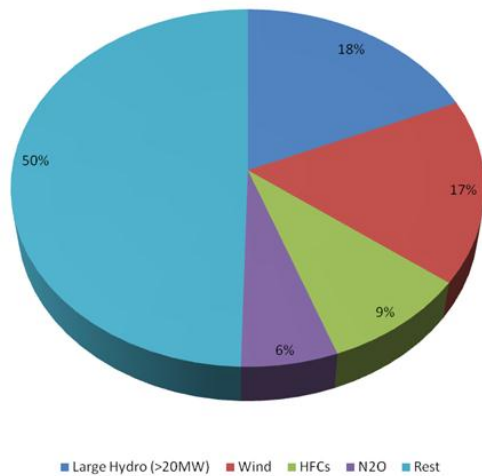


Figure 1: Expected CER issuance up to 2020 by project type (Source: UNEP RISOE, 23 May 2012)

In the event that the EU does decide to introduce demand side reforms to restrict large hydro credits a number of options are possible. These include adopting complete ban on credits from large hydro projects, a ban on credits from certain project categories only (e.g. from certain countries, new projects, projects built after a certain date etc), deciding on the eligibility of credits on a project-by-project basis and applying a discounting factor to credits (i.e. the automatic cancellation of a certain number of credits).

A full ban on large hydro credits could serve to eliminate the current over-supply

The CDM Integrity Study analyses the benefits and drawbacks of these respective options, concluding that blanket bans on all or certain credits are likely to face significant political and market opposition, while a project-by-project approach may be more acceptable, but would result in a substantial administrative burden that may make it less practical. Discounting factors, meanwhile, were found to result in major difficulties in agreeing on appropriate discounting rates, and would be likely to face significant political and market opposition. Ultimately, none of the options emerged as a clear preference, and which route the EU would follow if it decides to adopt restrictions may very much depend on political and market developments in the coming months and years.

Conclusion

While speculation has been widespread that the Commission may introduce restrictions on the use of

credits from large hydropower projects in the EU ETS, the Commission has been careful to state that it is not currently planning any such measures. There is consensus that current measures are insufficient to deal with criticisms concerning additionality and sustainability. However, with dialogue currently underway at UNFCCC level to reform the CDM on the supply side, future moves to introduce restrictions are likely to depend on whether meaningful reforms can be foreseen in the near to medium term. At the same time, the substantial effect on supply and demand in the EU ETS restrictions could bring about may provide the Commission with a further impetus to explore the options available, particularly where little progress emerges on a set-aside or strengthening the 20% by 2020 target. Where the EU does decide to introduce restrictions, several options are possible, and the lack of a clear preferred option means that any decision is likely to depend on the prevailing political, market and regulatory conditions.

¹ While future restrictions could apply to both CDM and JI projects, most concerns have arisen with respect to CDM projects, and so these are the focus of this brief.

² AEA, SEI, CEPS and CO2logic, *Study on the Integrity of the Clean Development Mechanism (CDM)*, December 2011, available on: http://ec.europa.eu/clima/policies/ets/linking/docs/final_report_en.pdf ["CDM Integrity Study"].

³ EU Commission, *Questions & Answers on use of international credits in the third trading phase of the EU ETS*, available at: http://ec.europa.eu/clima/policies/ets/linking/faq_en.htm.

⁴ EU Commission, *Questions & Answers on use of international credits in the third trading phase of the EU ETS*, available at: http://ec.europa.eu/clima/policies/ets/linking/faq_en.htm.

⁵ CDM Integrity Study, page 46.

⁶ Commission News Release, *Jos Delbeke: "Commission study provides input to the ongoing Clean Development Mechanism discussions"*, 16 December 2011, available at: http://ec.europa.eu/clima/news/articles/news_2011121601_en.htm.

⁷ CDM Integrity Study, pages 48-49.

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