

Submission on draft decision -/CP.16

Outcome of the work of the Ad Hoc Working Group on Long-Term Co-operative Action under the Convention, UNFCCC

Views on matters relating to the establishment of one or more market-based mechanisms to enhance the cost-effectiveness of, and to promote, mitigation actions, as referred to in document FCCC/AWGLCA/2010/L.7, paragraph 81. (See FCCC/AWGLCA/2010/L.7, paragraphs 80.82)

Submitted by Friends of the Earth International, accredited observer organisation to the UNFCCC, 21 February 2011

1. Summary

- Further clarification is needed on the distinction between market-based from non-market-based mechanisms for climate mitigation.
- A range of mechanisms can be considered as market-based, including carbon taxation, carbon trading, and feed-in tariffs, and it is important to distinguish between these.
- Carbon trading through the European Union Emissions Trading Scheme (EU ETS) – the world’s largest emissions trading scheme – has failed to drive emissions reductions at the pace necessary for Europe to contribute its fair share of global emissions reductions.
- In addition, carbon trading has been a very ineffective way of promoting and financing mitigation actions in Non-Annex I countries.
- All current and planned carbon trading mechanisms are reliant on offsetting and thus undermine environmental integrity and the world’s chances of avoiding catastrophic climate change in the context of very poor ambition of emissions reductions commitments from Annex I countries.
- Offsetting is an escape hatch for Annex I from their emissions reductions commitments, and the expansion of offsetting through the expansion of carbon trading shifts the burden of climate mitigation to developing countries. Current offsetting mechanisms like the Clean Development Mechanism also undermine sustainable development by locking developing countries into high carbon development pathways.

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- Current and planned carbon trading schemes are deeply flawed and the AWG-LCA should agree to halt any further expansion of carbon trading globally, and to prevent the international linking of existing emissions trading schemes.
- Non-market-based mechanisms, including regulatory interventions, should be foundational strategies for climate mitigation.
- Other market-based mechanisms such as carbon taxes and feed-in tariffs can play a constructive role in climate policy, but should not be the centrepiece of a strategy to reduce greenhouse gases, especially in an international context.

2. Introduction

We welcome the opportunity to present views on the establishment of new market-based mechanisms to enhance the cost-effectiveness of, and to promote, mitigation actions. We would like to begin by highlighting the lack of clarity that exists over which climate mitigation mechanisms can be distinguished as market-based and which are considered to be non-market-based. It will be important for the AWG-LCA to establish greater clarity on the distinguishing features of the two sets of mechanisms. For the purposes of this submission, the term 'market-based' will be used to refer to policy tools which seek to affect behaviour through a price mechanism.

In the context of climate mitigation, market-based tools include carbon trading and carbon taxation – both of which seek to reduce emissions indirectly by affecting the price of emissions and, in turn, the behaviour of actors responsible for producing them such as companies or individuals. In contrast 'non-market-based' tools are a much broader range of tools and policy interventions to change behaviour, and include more direct interventions to tackle emissions such as standard-setting on emissions from industry and other sectors.

It is important to note from the outset that market-based mechanisms do not operate in a vacuum, but instead must always be underpinned by other forms of intervention such as government laws and regulations. For example, the global carbon market is itself an artificially-created market, established through a series of legal decisions at international, national and regional levels.

Overall, it is the view of Friends of the Earth International that, while market-based mechanisms such as carbon taxes can play a constructive role in climate policy, we believe they should not be the centrepiece of a strategy to reduce greenhouse gases, especially in an international context. Furthermore, we consider the drive to expand one particular market-based mechanism - carbon trading - as the primary mechanism for tackling carbon emissions, to be an extremely high risk and irresponsible approach.

Pricing carbon is often considered to be the main strategy for reducing emissions, while other strategies such as regulatory intervention – for example the establishment of emissions performance standards - are mistakenly considered “complementary.” Instead, it

is argued here that non-market-based mechanisms, including regulatory interventions, should be foundational strategies for climate mitigation.

There are already many examples of direct interventions which have successfully delivered reductions in greenhouse gas emissions. For example, in California, the Air Resources Board was tasked with implementing the state's global warming law (AB32), which required greenhouse gases to be reduced by 169 MMTCO₂e by 2020. Although the state indeed decided to adopt a cap-and-trade system, the Board recommended a broad suite of GHG reduction strategies, including tightening building and appliance standards, conducting better transportation planning, increasing the renewable portfolio standard, and the single largest strategy to reduce GHGs (accounting for over reductions of 31 MMTCO₂e) - adopting new light duty vehicle standards.¹

As the Board explained in its Scoping Plan, "Within the capped sectors, some of the reductions will be accomplished through direct regulations such as improved building efficiency standards and vehicle efficiency measures. Whatever additional reductions are needed to bring emissions within the cap are accomplished through price incentives posed by emissions allowance prices."² Indeed, carbon pricing can complement other mitigation strategies, but it simply cannot take the place of other measures, such as basic urban planning, public infrastructure investments such as mass transit, etc.

3. Market mechanisms

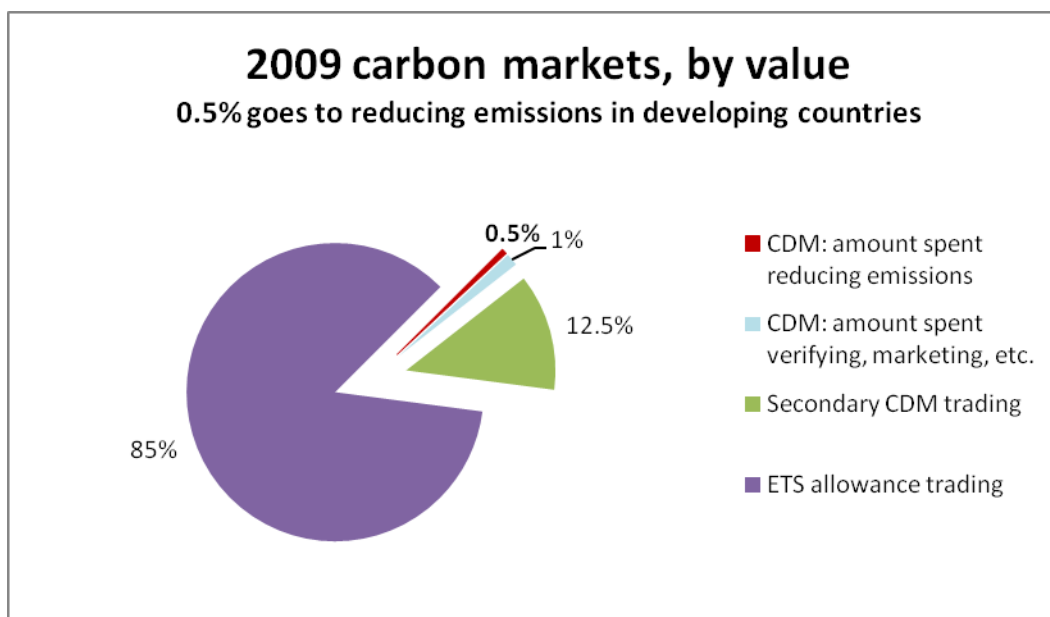
3.a The failure of carbon trading

The AWG-LCA has particularly solicited the input of observer organizations on several aspects of market-based mechanisms, including cost-effectiveness, environmental integrity, equity, and good governance. It is becoming increasingly clear that carbon trading is failing on each of these counts.

3.a.1 Cost effectiveness

For Annex I countries, the "efficient markets" theory behind carbon trading posits that pricing carbon will help the market make the cheapest emissions cuts first. Although prioritizing the cheapest emissions may be politically desirable in the short-term, it may not actually be efficient in the long term. Seeking out the cheapest emissions reductions first may delay more expensive yet critical investments which are needed to transition to a low-carbon economy. As relatively cheap mitigation measures are prioritized, it may reduce incentives to implement more aggressive and timely climate strategies, or fail to prevent high-carbon investments today which may lock in emissions for decades.

Second, carbon trading has been a spectacularly ineffective way of promoting mitigation actions in Non-Annex I countries. Although global carbon markets have been valued at over \$100 billion in the last few years, only one half of one percent of the money in the EU ETS and CDM market actually capitalize offset projects in developing countries.



Although the primary CDM market was valued at approximate \$2.4 billion in 2009³, only about 31 per cent of total funds received for CDM credits capitalize mitigation projects in developing countries. The total amount of funds spent on developing country climate mitigation is closer to \$830 million, or about 0.5% of the carbon market value; with the remaining percent going to carbon traders, brokers, verifiers, project developers, etc.⁴

The answer to more efficiently achieve reductions in Non-Annex I countries is not to increase the proportion of offsets in Annex I countries, as that only increases risks and erodes environmental integrity (see below), but to develop innovative financing mechanisms to support NAMAs.

There is widespread research pointing to the potential of innovative sources of public finance in Annex I countries to support climate mitigation by developing countries. Recent research by Friends of the Earth England, Wales and Northern Ireland examined five of these innovative sources: a new global Financial Transaction Tax (FTT); cutting Annex I public subsidies to fossil fuel producers; cracking down on tax evasion in Annex I countries by multinational companies and wealthy individuals; new, well-targeted carbon and energy taxes in Annex I countries; and increased Special Drawing Rights (SDRs) at the IMF, transferred to developing countries without interest repayments. Conservative estimates of the revenue-raising potential of those five solutions indicated that they could provide at least \$420 billion per year for developing country mitigation⁵.

3.a.2 Environmental integrity

It is the view of Friends of the Earth International that a decision at the UNFCCC to expand carbon trading globally would not be compatible with environmental integrity. This is due to the context of a very poor level of ambition in terms of emissions reduction commitments from Annex I countries and the reliance of all existing and planned carbon trading schemes on offsetting.

The UNFCCC requires all countries to take decisive action on climate change. However, recognising the principle of Common But Differentiated Responsibility (CBDR) and the fact that developing countries still have to address pressing social development needs, rich countries are committed under the Convention to acting first and fastest to reduce their emissions. Discussions are currently underway in the negotiations as to what a fair division of the remaining global carbon budget would look like. This budget corresponds to the volume of greenhouse gas emissions that can still be emitted globally, while keeping overall emissions in the atmosphere below levels considered to present an unacceptable risk of catastrophic climate change. Overall, the remaining global carbon budget compatible with a reasonable chance of avoiding dangerous climate change is in all likelihood extremely small. If the historical responsibility of developed countries for the problem of climate change is fully taken into account as fairness and justice necessitate, then they will have to deliver dramatic domestic emissions reductions over the next decade.

One of the more conservative approaches for dividing the remaining global carbon budget equitably divides this budget on the basis of projected per capita population 2010-2049, not taking into account the historical emissions of different countries. Even on the basis of this conservative approach, deep emissions reductions of 56% for the UK, 60% for the EU and 74% for the USA by 2020 on 1990 levels are necessary if we are to keep global greenhouse gas emissions below 1,100 GtCO₂e⁶. This would also still constitute a risk of 30% of exceeding a global temperature increase of 2 degrees, a temperature threshold which would still have devastating impacts for Africa and many low-lying small island nations. In contrast to these deep emissions cuts needed by Annex I countries, actual emissions reductions commitments from Annex I countries currently made under the UNFCCC add up to only a 12-18 per cent reduction on 1990 levels by 2020.⁷

Current carbon trading mechanisms provide Annex I countries with an escape hatch from these already very low commitments by allowing for offsetting. All new proposals for the extension of carbon trading, including proposals put forward for the establishment of sectoral trading, would extend this escape hatch, increasing opportunities for offsetting by Annex I countries and thus further undermining the environmental integrity of mitigation and further reducing the world's chances of avoiding catastrophic climate change.

3.a.3 Equity

The above considerations regarding the expansion of carbon trading in the context of a fair division of the remaining global carbon budget have implications not only for environmental integrity but also for equity. As already highlighted, all existing and planned carbon trading schemes rely on offsetting. Offsetting shifts the burden of climate mitigation from the developed countries which are primarily responsible for creating the problem of climate change, to developing countries whose basic development needs – expanding energy access for improving living standards and access to public services like healthcare, water and sanitation – necessitate that they continue to increase their emissions for longer. Offsetting therefore undermines the equitable sharing of the remaining global carbon budget. The expansion of carbon trading will therefore further burden developing countries with responsibility for tackling the problem of climate change when they did the least to create the problem in the first place. For example, proposals put forward for new sectoral carbon

trading mechanisms could involve financial sanctions for developing countries if they fail to achieve the targets set, and no guarantee of financing for developing country mitigation in key economic sectors for their 'own action' to reduce emissions in these sectors. Other proposals, such as 'green sectoral bonds', could also constitute a new source of developing country debt to private creditors.

3.a.4 Sustainable Development

The overwhelming majority of mitigation and adaptation projects which will truly benefit people in developing countries are not profitable and therefore of little interest to the carbon markets. Relying on carbon trading to support the extension of small-scale, sustainable and locally-appropriate mitigation projects is therefore inadvisable. The failure of carbon trading to support mitigation mechanisms compatible with sustainable development is already evidenced by the projects supported by the Clean Development Mechanism (CDM). More than one quarter of offset credits estimated to be issued in 2012 from CDM projects in the pipeline will come from large firms making minor technical adjustments at a few industrial installations to reduce greenhouse gases. Only 11 per cent are projected to come from projects involving the production of renewable energy from wind or solar.⁸ Carbon markets also focus investment in well capitalised corporations rather than small-scale community led projects which can't afford initial financial outlays.

3.a.5 Governance

Another area where carbon trading has clearly failed is in the area of good governance. The complexity of the trading process has permitted considerable gaming and abuse of the system. As of mid-February 2010, only six out of thirty European registries had been permitted to open again, after the EU halted trading in the wake of the largest scandal in the history of the European Union Emissions Trading System (EU ETS). This scandal involved the wholesale theft of millions of Euros of allowances from registries, and has occurred on the heels of several other high-profile incidents. About a year ago, Europol reported that carbon criminals had committed tax fraud in the carbon markets worth about €5 billion; and for a time, an estimated 90% of trading volume on Paris-based BlueNext, a carbon exchange, was tied to fraudulent activities.

Scandals such as these are not simply "growing pains" for a relatively new market; they are the inevitable outcome of a concept that sounds elegant in an economics textbook, but fails in the real world. Today's scandals involve opportunists exploiting immature trading structures, systems and rules. Tomorrow's scandals will involve more sophisticated gaming around complex and unwieldy trading systems, with the offsets market posing the most risk for fraud and corruption. Later, as/if the market becomes larger and more mature, it will suffer from the distorting impacts of unnecessary speculation and excessive financialization. At the heart of the problem is the fact that carbon trading entrenches the interests of those who profit from the selling/trading of credits and allowances, rather than the actual reduction of emissions. This dynamic can exacerbate conflicts of interest, increase corruption risks, and create regulatory capture. Already, associations such as the International Emissions Trading Association have lobbied against stricter derivatives regulations, and criticised UN officials for not approving offsets fast enough.

3.b. Other market mechanisms

3.b.1 Carbon taxes

Although carbon pricing should not be the centrepiece of a greenhouse gas reduction policy, it can be a helpful addition to a portfolio of other strategies, such as performance standards and regulations. In light of carbon trading's grave failures in environmental effectiveness and governance, the AWG-LCA should consider carbon fees or taxes as an alternative for pricing carbon.

Compared with carbon trading, taxes are easier to implement, less easily manipulated, and can serve as a source of revenue for climate finance or public investments in mitigation. The EU ETS serves as a prime example of how difficult it is for carbon trading to achieve these characteristics in practice. But one of the most compelling arguments in favour of carbon taxes is efficiency. A report by the US Congressional Budget Office, which studied policy options for reducing greenhouse gas emissions, concluded that: "A tax on emissions would be the most efficient incentive-based option for reducing emissions and could be relatively easy to implement."⁹ Firms need certainty in balancing the benefits and costs of reducing emissions, and carbon taxes provide a steady and predictable price signal which is critical to stimulating investments in low-carbon alternatives. In contrast, carbon markets thrive on price volatility. For these and other reasons, carbon taxes have garnered some notable supporters, including Nobel Laureate Joseph Stiglitz and James Hansen, Director of the US NASA Goddard Institute for Space Studies.

3.b.2 Feed-in tariffs

Another market-based mechanism which has a great potential for mobilizing greenhouse gas emissions reductions is the Feed-in Tariff (FIT). FITs are one of the world's most effective strategies to ramp up deployment, and thus bring down the costs, of renewable energy. Almost 90 percent of the growth that has occurred in Europe's wind energy sector since 1995 has occurred in countries with FITs.¹⁰ By providing guaranteed grid access and stable, profitable prices for renewable energy investors (which go down over time), renewable energy companies are encouraged to increase production as quickly as possible.

Rather than making carbon-intensive energy more expensive, a FIT makes clean energy more cheap, and thus is a promising way to address energy poverty and increase energy access in developing countries. FITs are also efficient in that only projects which successfully deliver renewable energy actually benefit from the subsidy. In light of the successful track record of FITs, the AWG-LCA should consider a global FIT as it debates other market mechanisms for reducing global greenhouse gas emissions.

4. Current mechanisms

Information has also been requested by the UNFCCC on the evaluation of various approaches in enhancing the cost effectiveness of, and promoting, mitigation actions, including activities implemented jointly under Article 4, paragraph 2 (a) of the Convention

and any other relevant activities. Reflections here are confined to comments on the Clean Development Mechanism (CDM) – the official offsetting scheme sanctioned by the Kyoto Protocol – and the EU ETS as the experiences of these mechanisms are considered to be most relevant to the discussion within the UNFCCC regarding the expansion of market-based mechanisms.

4.a Clean Development Mechanism

Fundamental problems were outlined above in relation to the CDM's existence as an offset mechanism for Annex I emissions in the context of very poor Annex I emissions reductions commitments and a very small remaining global carbon budget. In addition, problems have been highlighted with the types of mitigation projects in developing countries financed through this mechanism. The drive for profitability which motivates most investments in CDM projects means that projects which gain support under the scheme are often the lowest cost options, which are the least beneficial from the perspective of climate mitigation and setting developing countries onto low-carbon development pathways.

Fossil fuel-intensive projects such as new coal-fired power stations qualify for CDM credits as long as they can demonstrate marginal improvements in emissions compared to similar projects nearby. The CDM is therefore playing a role in helping to lock developing countries into high carbon development pathways, increasing the costs that these countries will face in the medium- to long-term in transitioning to a low-carbon industrial base.

Recent research on the CDM has also exposed widespread gaming and abuse of the system carried out by polluting industries seeking to qualify for offset credits under the scheme. Most recently, the watchdog CDM-Watch exposed widespread abuses by the producers of HFC-23, a potent greenhouse gas which is a by-product of the refrigerant gas HCFC-22. CDM-Watch argued that the HFC-23 destruction projects under the CDM offsetting mechanism were actually having the opposite of the intended effect, i.e. they were contributing to increasing global greenhouse gas emissions¹¹.

4.b European Union Emissions Trading Scheme (EU ETS)

The European Union Emissions Trading System (EU ETS), the world's largest emissions trading scheme, has failed to drive emissions reductions at the pace necessary for Europe to contribute its fair share of emissions reductions. As highlighted by Friends of the Earth Europe, the first carbon trading trial phase in 2005-2007 was an abject failure. At 2298 million tons of CO₂, the 2007 cap was actually 8.3% higher than verified 2005 greenhouse gas emissions¹². Declines in emissions covered by the scheme have been reported under the current, second phase of the scheme (2008-12), with overall emissions covered by the EU ETS showing a drop of 11.2 per cent in 2009¹³. However, a significant proportion of this decline was due to the drop in industrial production across Europe brought about by the economic crisis, rather than due to any strong incentives provided by the EU ETS.

It is now widely acknowledged that the EU ETS is failing to deliver adequate incentives for emissions reductions and investment in new technologies by highly-polluting European industries. Increasingly European governments are looking at more direct interventions in their economies to bring down emissions, including direct regulation and taxation.

In the UK, the highly respected Committee on Climate Change confirmed in 2009 that it lacked confidence in the ability of the EU ETS to deliver the required low-carbon investments in the energy sectors covered by the scheme through the 2020s. It recommended that “a range of options [such as regulation and taxes] for intervention in carbon and electricity markets should be seriously considered.”¹⁴

5. Conclusions

- **Further clarification is needed on the distinction between market-based from non-market-based mechanisms for climate mitigation.**
- **A range of mechanisms can be considered as market-based, including carbon taxation, carbon trading, and feed-in tariffs, and it is important to distinguish between these.**
- **Carbon trading through the European Union Emissions Trading Scheme (EU ETS) – the world’s largest emissions trading scheme – has failed to drive emissions reductions at the pace necessary for Europe to contribute its fair share of global emissions reductions.**
- **In addition, carbon trading has been a very ineffective way of promoting and financing mitigation actions in Non-Annex I countries.**
- **All current and planned carbon trading mechanisms are reliant on offsetting and thus undermine environmental integrity and the world’s chances of avoiding catastrophic climate change in the context of very poor ambition of emissions reductions commitments from Annex I countries.**
- **Offsetting is an escape hatch for Annex I from their emissions reductions commitments, and the expansion of offsetting through the expansion of carbon trading shifts the burden of climate mitigation to developing countries. Current offsetting mechanisms like the Clean Development Mechanism also undermine sustainable development by locking developing countries into high carbon development pathways.**

6. Recommendations

- **Current and planned carbon trading schemes are deeply flawed and the AWG-LCA should agree to halt any further expansion of carbon trading globally, and to prevent the international linking of existing emissions trading schemes.**
- **Non-market-based mechanisms, including regulatory interventions, should be foundational strategies for climate mitigation.**

- **Other market-based mechanisms such as carbon taxes and feed-in tariffs can play a constructive role in climate policy, but should not be the centrepiece of a strategy to reduce greenhouse gases, especially in an international context.**

7. Further Reading

Please refer to the following documents for further information and elaboration on the positions outlined above:

- *Clearing the Air: Moving on from carbon trading to real climate solutions*, Friends of the Earth England, Wales and Northern Ireland (November 2010): http://www.foe.co.uk/resource/reports/clearing_air.pdf
- *Subprime Carbon*, Friends of the Earth US (March 2009): <http://www.foe.org/pdf/SubprimeCarbonReport.pdf>
- *The EU Emissions Trading System: Failing to deliver* (October 2010): http://www.foeeurope.org/climate/download/FoEE_ETS_Oct2010.pdf
- *Dangerous Obsession: The evidence against carbon trading and for real solutions to avoid a climate crunch*, Friends of the Earth England, Wales and Northern Ireland (November 2009): http://www.foe.co.uk/resource/reports/dangerous_obsession.pdf

8. Further Information

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- 1 See AB 32 Scoping Plan Document at http://www.arb.ca.gov/cc/scopingplan/document/adopted_scoping_plan.pdf
 - 2 AB 32 Scoping Plan Appendix C, p 14 at http://www.arb.ca.gov/cc/scopingplan/document/appendices_volume1.pdf
 - 3 *State and Trends of the Carbon Market 2010*, World Bank, 2010.
 - 4 *The efficiency of carbon offsetting through the Clean Development Mechanism*, Carbon Retirement, 2009.
 - 5 *Clearing the Air: Moving on from carbon trading to real climate solutions*, Friends of the Earth England, Wales and Northern Ireland, November 2010: http://www.foe.co.uk/resource/reports/clearing_air.pdf

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- 6 *Reckless Gamblers: How politician's inaction is ramping up the risk of dangerous climate change*, Friends of the Earth England, Wales and Northern Ireland, December 2010
 - 7 http://www.twinside.org.sg/title2/climate/news/Bonn07/TWN_bonn7.up06.pdf
 - 8 UNE P Risoe CD M/JI Pipeline Analysis and Database, 9 Nov 2010.
http://www.cdmpipeline.org/publications/CD_Mpipeline.xlsx .
 - 9 *Policy Options for Reducing CO2 Emissions*, US Congressional Budget Office, February 2008 at
<http://www.cbo.gov/ftpdocs/89xx/doc8934/02-12-Carbon.pdf>
 - 10 *The Double Challenge Feed-in Tariffs and Front-loaded Investments*, Swedish Society for Nature Conservation (SSNC) at
http://www.naturskyddsforeningen.se/upload/Foreningsdokument/Klimat/Knackfragor/fakta_2_web.pdf
 - 11 CD M Watch, *UN Under Pressure to Halt Gaming and Abuse of CDM* http://www.cdm-watch.org/wordpress/wp-content/uploads/2010/06/hfc-23_press-release_gaming-and-abuse-of-cdm1.pdf .
 - 12 Friends of the Earth Europe, *The EU Emissions Trading System: Failing to deliver*, October 2010
http://www.foeeurope.org/climate/download/FoEE_ETS_Oct2010.pdf
 - 13 Szabo & Wynn, *EU ETS CO 2 emissions down 11.2 pct in 2009*, Reuters, 1 April 2010.
 - 14 UK Climate Committee, *Meeting Carbon Budgets – the need for a step change*, 2009, chapter 2, p70.
<http://www.theccc.org.uk/reports/1st-progress-report>