sandbag
smarter climate policy

Repair kit for ESR flexibilities

How to drive action and cooperation within the non-traded sectors

November 2017

Main recommendations

- **Adopt the provisions on the LULUCF flexibility from the European Parliament, allowing the use of this flexibility for compliance only, after having exhausted any banked surplus of ESR credits. Introduce similar provisions for the ETS flexibility;**
- **Provide a strong mandate for the establishment of a European Project Based Mechanism. Adopt the provisions as proposed by the Council, and improve these by making them recommended or even a prerequisite for transfers;**
- **Provide more transparency on concluded transfers, to stimulate further trade and cooperation between member states.**

About Sandbag

Sandbag is a London and Brussels-based not-for-profit think tank conducting research and campaigning for cost-effective climate policies.

Our research focus includes reforming the EU Emissions Trading System and the Effort Sharing Decision; accelerating the phase-out of old coal in Europe; and deep decarbonisation of industry through technologies including Carbon Capture & Storage.

For more information, visit sandbag.org.uk or email us at info@sandbag.org.uk

Recap: why flex it?

In order to account for solidarity concerns, national targets for the Effort Sectors have been heavily differentiated based on relative wealth (GDP/capita). This approach prevents a cost-effective achievement of our overall target, and therefore also reduces political support for more ambition (see also “Bend it, don’t break it” and “The missing link” for more info this).

However, trading between member states has been put forward as a solution to better match efforts with cost-effective reduction opportunities spread across member states. It could indeed do the job, provided the trading takes places in a transparent way which prioritises additionality of credits surrendered.

There are several other benefits to the use of cooperation between member states to achieve their targets under the ESR: they maintain the overall reduction incentive for the sectors under the ESR, they facilitate technological transfer, and they stimulate financial flows and job creation in lower-income member states, contributing to overall economic convergence. Last but not least, they allow for better identification of reduction opportunities by involving the private sector (when using transfers based on reduction projects).

Broken logic: exemptions made the rule

The aim of the ESR is to reduce emissions of the non-traded sectors, and to put these sectors on track towards a low-carbon society by 2050. Member states can choose whether they want to achieve those reductions within their own borders, or in other member states by using the possibility of transfers.

In addition, two "external" flexibilities (with the EU ETS and with the LULUCF) were introduced to provide further relieve *in case* the cost of reductions within the ESR sectors would get *too high*. However, instead of providing a rulebook for these exemptions, the ESR as it is now makes the exemption the rule. With the current design, we expect that Member States will first exhaust the two external flexibilities before making use of the possibility to trade and cooperate with member states[1].

This has several drawbacks:

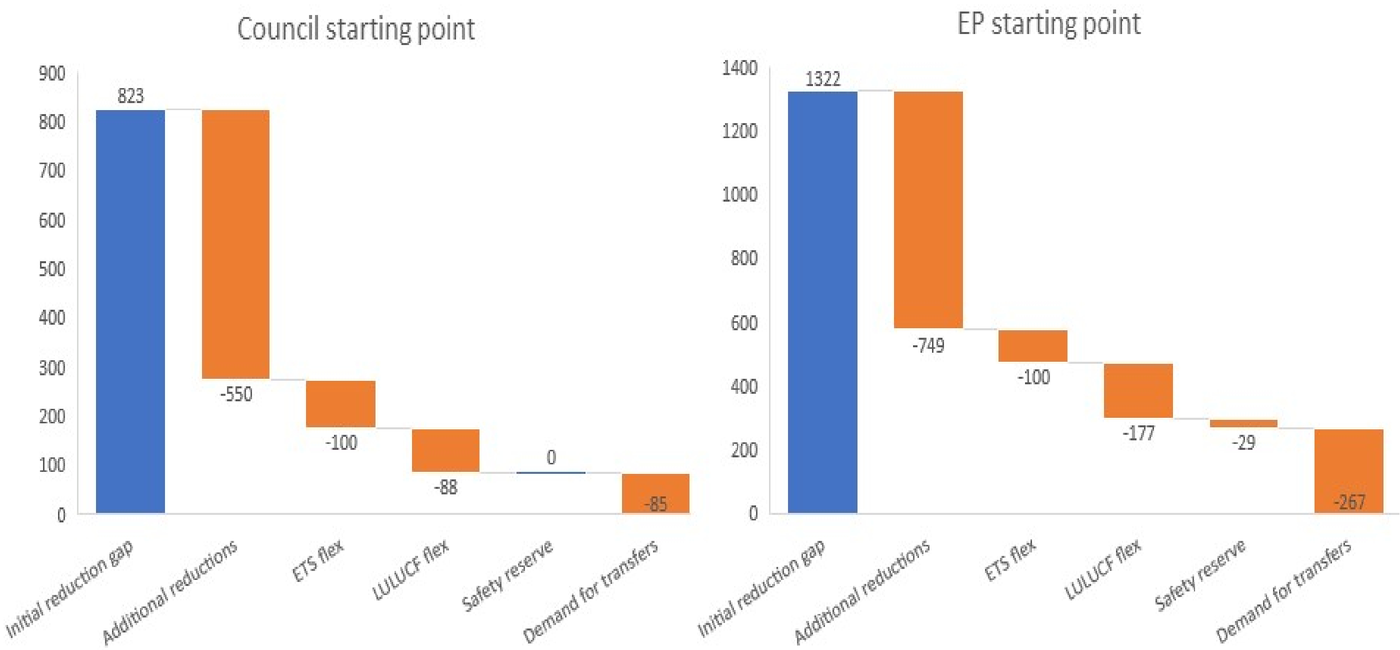
1) The use of external flexibilities increases the overall ESR budget and therefore dilutes the incentive for reductions within the Effort Sharing sectors, putting them off track for our long-term targets.
2) It's doubtful that these external flexibilities would bring additional reductions in the short term, in particular in the case of the EU ETS which is plagued by a persistent surplus. As they allow less reductions in the ESR without achieving additional reductions elsewhere, their use undermines the achievement of the overall EU 2030 target;
3) Finally, these external flexibilities don't have the co-benefits of cooperation within the ESR between member states, as mentioned above.

ESR flexibilities: a logic turned upside down

[1] Firstly, the use of ETS and LULUCF credits doesn't involve the administrative burden of having to reach an agreement with other member states. Secondly, we expect these flexibilities to be cheaper: LULUCF credits - especially from Forest Management - can be generated relatively easy. The ETS will still have a large surplus in phase 4, leading to persistent low prices. Thirdly, given the certainty of supply, member states will be inclined to apply for maximum use of the ETS flexibility in 2019.

Undermined demand for trading and cooperation within the ESR

Due to an inflated budget and easy access to external flexibilities, we have analysed there will be low demand for trade and cooperation within the ESR. Under the Council position, **the demand for transfers could be as low as 85 million tonnes**. With the more ambitious starting point of the European Parliament, the demand would increase to 267 million tonnes.



The graphs above show the aggregate reduction gap (in Mt) of all member states with an expected negative balance for the period 2021-2030[2]. It is already assumed that member states will make maximum use of banking and borrowing, so the reduction gap shows the aggregate balance for the whole period 2021-2030.

It is then assumed that these member states will first make use of the cost-effective potential to reduce emissions within their own borders[3]. There is a good reason to assume this: it would help those member states to achieve future, more stringent reduction targets as well as their objectives regarding energy efficiency and renewable energy production, it would allow them to reap the co-benefits of emission reductions, and it would be easier to explain to the taxpayer. Only when the cost of domestic reductions would get too high, member states would turn to flexibilities.

Member states would then make use of the two external flexibilities and the Safety Reserve[4], given the easy access and the expected low costs.

Only after exhausting these options, member states would turn to trading and cooperation with other member states to fill any remaining reduction gap. **This means they will make only very limited use of the opportunities for trading and cooperation within the ESR.**

[2] The starting point is based on 2016-2018 emissions from the most recent WEM projections. The emissions from 2021 to 2030 are based on the 2016 Reference scenario of the European Commission.

[3] Based on the EUCO30 scenario.

[4] Under the assumption that all member states would reduce in line with the EUCO30 scenario), the Safety Reserve would not be used with the Council starting point (and only partially with the EP starting point). Of course, it can be imagined that some member states may decide to use the Safety Reserve before exhausting their cost-effective reduction potential.

Repair kit to fix the ESR Flexibilities

There are ways to fix this. Reducing the overall budget by e.g. a tighter starting point already increases the overall demand for flexibilities, and thus also for transfers (see e.g. the impact of a more ambitious starting point above). There are also opportunities to improve the design of the various flexibility mechanisms themselves.

Allow external flexibilities only as a 'last resort' option

Both the Council as the EP have failed to reduce the overall limit on the two external flexibilities. If they are included in the ESR, they should at least be available only as a last resort after using other options ***within*** the ESR:

- ➔ In this regard, **we welcome the position of the EP on the LULUCF flexibility**, making it only available for compliance after using the original budget under the ESR, **including any banked surpluses from previous years**. The Council should at least accept this improvement.
- ➔ **A similar provision should also be included for the ETS flexibility**, to ensure it can only be used when other options have been exhausted. This would benefit the environmental integrity of the ESR, but would also ensure equal treatment of the ETS and the LULUCF flexibility.

Incorporate the use of European Project Mechanisms to ensure additionality of transfers

Even if member states would opt to make use of transfers within the ESR rather than external flexibilities, there is still a risk that this won't bring any additional reductions or benefits. Especially in the case of a too large budget – as is the case with the Council position on the starting point – there is a risk that trading between member states will be no more than transferring hot air. A European Project-Based Mechanism or EPM (including the possibility for a Green Investment Scheme-type approach) mitigates this risk, and ensures that transfers between member states result in additional action.

- ➔ We therefore **welcome the Council's additions under paragraph 5a and 5b of Article 5**, which give more visibility to this option;
- ➔ This proposal could even be improved by making use of these options **recommended or even a prerequisite for transfers**.

Ensure more transparency and facilitation to support trade and cooperation between member states

Further measures are needed to facilitate trade and cooperation between member states. By increasing transparency and reducing transaction costs.

In particular, more transparency is needed on concluded transfers, including on overall volumes and prices. This would enable price discovery and could trigger further transfers and reduction-projections.

- ➔ As for any well-functioning market, there needs to be **more transparency on concluded transfers**, including on volumes and prices.

About this briefing

We are grateful for the support of the KR Foundation for helping to fund this work. Full information on Sandbag and our funding is available on our website (www.sandbag.org.uk).

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