Question 1: How can the availability and use of the two existing internal flexibility instruments under the ESD be enhanced to ensure cost-effectiveness of the collective EU-effort in 2021-2030: a) for banking and borrowing; and b) for AEA transfers among Member States, respectively?

Use of international credits

The question rules out the use of international credits from any of the UN's mechanisms, which is one of the existing flexibility instruments currently available for Member States to meet their Effort Sharing Target until 2020. **IETA recommends that the use of international credits remains a possible flexibility instrument for Member States to meet their Effort Sharing Target after 2020**. For a cost-effective operation of the Effort Sharing Decision, it will be necessary to include flexibility measures. Climate change being a global problem, a global solution is necessary, and thus international flexibility is extremely important. While mitigation within the EU is necessary, the use of UN-certified international credits are essential to the global system. They represent cost-effective abatement opportunities and provide further liquidity to the market. They also provide support to the global infrastructure for emission reductions (DOEs, consultants, project developers, UN bodies, etc.). They provide a global price signal, encourage and reward reductions in all countries including those without binding targets yet, encourage early adoption of new technologies, etc. Failure of the EU to allow and promote the use of these international credits is likely to lead to a dramatic decline in capacity to implement, monitor and report emission reductions in developing countries.

We propose that this very limited entitlement to use international credits under the Effort Sharing Decision should be recognised by the EU, particularly those credits from LDCs and eligible under the EU ETS.

Rules for using these credits need to be transparent and reliable. Predefined limits for such credits should be spelt out in advance in the Effort Sharing legislation.

Even if the EU's current target of at least -40% by 2030 only refers to domestic reductions it should be acknowledged that 1) the EU target might be increased as a result of the UN negotiations and supplemented with a new climate target which includes the use of international offsets and 2) individual Member States could decide to take on higher national climate targets compared to what the ESD stipulates. In those cases, they should be free to wholly or partly recognise the use of offset credits for the nationally determined extra effort.

Banking and Borrowing

IETA believes the approach under the ESD should be in line with the same principles as in the ETS. **Banking** should be considered an important option to both enhance cost-effectiveness and encourage early action and also because the transfer of allowances in the ETS for the next trading periods is also allowed. **Borrowing** should not be allowed as it fails to encourage emission reduction actions, and is also not allowed in the ETS.

AEA transfers amongst Member States

It is also important to encourage better use of the existing flexibility mechanisms, including the transfer of AEAs between Member States under Article 5.6 of the Effort Sharing Decision. Member States could choose to pool their respective unused allowances, which could represent an additional flexibility mechanism.

Such transfers should comply with the same rules as other mechanisms under the UN agreements. Therefore, such transfers should "deliver real, permanent, additional and verified mitigation outcomes, avoid double counting of effort, and achieve a net decrease and/or avoidance of greenhouse gas emissions".

It may be worthwhile considering increasing the limits for the flexibility instruments, to allow greater

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flexibility for the sales of AEAs from Member States in any year, and between Member States.

Question 3: How can cost-effectiveness be reflected in a fair and balanced manner in adjusting individual ESD targets for Member States with a GDP per capita above the EU average? What can be the role of the one-time reduction through a limited amount of ETS allowances in achieving these Member States' ESD targets, while preserving predictability and environmental integrity?

Cost-efficiency and a fair burden sharing should be the leading principle when setting ESD targets. **IETA does not support the proposed intervention, preferring instead that ESD targets be met by increased trading between Member States, and by investing the proceeds of auctioning in emission reductions.**

However, the **extension of the ETS price signal to non-ETS sectors could enhance the economic efficiency of GHG abatements**, ensuring higher transparency of associated costs and greater flexibility in meeting the objectives. It can **also help pave the way for a single economy-wide carbon price signal**. An**y new flexibility mechanism must contribute to strengthening the ETS and enhance incentives to decarbonise in non-ETS sectors** according to a harmonised carbon price signal.

It is important that any one-off reduction mechanism does not cause distortions in the ETS market. ETS sectors are already undertaking the largest effort in reducing GHG emissions and cannot be expected to take additional burden because emissions have not been reduced in non-traded sectors.

How to implement this one-time reduction?

The wording suggests there is an effective transfer of emissions rights from the ETS to non-ETS sectors. Allowances are withheld from the EU ETS by a one off reduction, which essentially means that the cap is reduced and consequently more can be emitted by non-ETS sectors while still meeting the overall 2030 EU GHG target. This will therefore have an impact on the amount of EUAs available in the EU ETS.

There are already ways in which Member States with significantly higher reduction targets than the EU average and above their "cost-effective reduction potential" can access emission credits from other Member States with a lower cost of compliance. When the mechanism is described as being 'limited', this has to be clearly defined in advance, and equate to no more than a low single digit percentage of the eligible Member States' share of the total annual volume of ETS allowance, including both free and auctioned allowances.

Basic principles to respect

A key principle to respect is the need for **predictability**. It is essential that any new flexible mechanism avoids unsettling the market by having new elements affect it without notice, or in an arbitrary or last minute manner. **It should be emphasised that this flexibility will be a one-off measure to be announced well in advance of Phase 4**, i.e. by 31 December 2016**.**

It also needs to be clarified what is meant by a "limited" reduction. The relationship with the MSR is also something that deserves to be looked into further. If this kind of a mechanism is to be introduced, predictable and transparent rules regarding the schedule and volumes should be ensured.

Guaranteeing environmental integrity: The presumption is that these allowances will remain unavailable to the ETS sector and cannot be auctioned. Consequently, the auctioned amounts for qualifying Member States in the period 2021-30 would be reduced. The monitoring and verification of the use of the transferred emission allowances should ensure that they are used 'appropriately' (i.e. used to reduce emissions in ESD sectors where it is not 'cost effective' to do so).

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Questions arise about the justification to use the GDP of a country compared to the EU average in 2013, when this flexibility instrument will apply post-2020. **The GDP year that is used should be more contemporary, and rolled forward on a year by year basis, and as a moving average.**

Question 5: Is the current scope of EU-wide action and legislation OTHER than the ESD to support Member States' emission reductions in ESD sectors sufficient, or should it be enhanced?

It is essential to monitor different countries' approaches for reducing emissions, in order to assess the extent of indirect overlap of such national measures with the EU ETS. A European scope is preferable to national approaches.

IETA believes the EU ETS is the best instrument to reach carbon reduction targets in an efficient and transparent way. An ETS allows trading between periods and it inherently offers flexibility over time. The ESD tries to bring flexibility over time and economic efficiency in the non-ETS sectors. Member States have frequently used flexibility over time by banking or borrowing between different periods but have so far not made use of the option to transfer emission reductions amongst themselves. As a consequence, the ESD is not being used to its full potential. As the number of sectors participating in the ETS increases, the number of sectors covered by the ESD should decrease.

A proposed way forward to ensure better coordination between European and national policies would be to adapt the level of EUAs available to Member States that have other emission reduction policies in place (such as carbon taxes), to disincentivise introducing national policies with no EU coordination.

The consistency of targets in non-ETS sectors should be enhanced with a clear focus on carbon emission reduction. The EU ETS takes care of the increase of renewable energy and energy efficiency in the ETS sectors, but additional measures for renewables and energy efficiency are needed in non-ETS sectors. It is important that policies in the non-ETS sectors are designed with a view to ensuring a cost-effective overall EU climate policy and specifically to avoid EU-internal CO2 leakage. **There should be a comparable CO2 price signal in non-ETS sectors** and this is especially important for activities (e.g. individual heating) that compete with ETS-activities (e.g. CHP / district heating).

We have concerns with the opt-in and opt-out provisions of the EU ETS that have enabled European Member States to nationally include or exclude some sectors. An example of such an approach is waste incineration. **In order to avoid market distortions each sector should be uniformly either included in or excluded from the ETS as a whole.**

Overall, the aim should be to expand the ETS to as many sectors as cost efficiently and practically as possible i.e. bring more emissions into the scope of the EU ETS while at the same time tightening the CO2 target. An expansion is only acceptable if the cap is adjusted according to the new sector's emissions and abatement potential. There are currently a couple of sectors that are split between both ETS and non-ETS obligations, such as heating and cooling, and transport. The heating and cooling sector accounts for about 45% of the final energy consumption in Europe. District heating and electric heating are included in the EU ETS and represent 25% of final energy consumption in the sector. The remaining 75% of final energy consumption in the heating sector falls under the ESD. The same applies for transport where electric transport is part of the EU ETS, but conventionally fuelled vehicles are excluded. However conventionally fuelled transport pays high fuel duties, as well as carbon taxes in many Member States. Regarding the transport sector, the emphasis should be placed on cost-effective and technology neutral measures to promote CO2 reductions.

Although a more harmonised approach to regulation is preferred, situations may vary largely between Member States. We encourage the European Commission to study areas of potential common interest. If an EU standard cannot be achieved then no regulation should be proposed. Having an EU Directive that allows Member States a wide variety of compliance options is

bureaucratic and can be counter-productive. Greater transparency on effective emission reductions in non-ETS sectors would be helpful, as well as publicly disclosing this information.