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Budapest, 15 February 2011

Subject: **New market-based mechanisms to enhance the cost-effectiveness of, and to promote, mitigation actions**

Introduction

1. The EU welcomes the decision at the COP16 in Cancun to consider the establishment, at its seventeenth session, of one or more market-based mechanisms to enhance the cost-effectiveness of, and to promote, mitigation actions.
2. Establishment of new market-based mechanisms is essential to undertake ambitious mitigation action by all countries. Therefore, the EU looks forward to the establishment of new market-based mechanisms at COP17 in Durban and sees it as an important part of a balanced package. Decisions from Durban should provide clear guidance for the characteristics of these mechanisms and for the development of modalities and procedures soon thereafter.
3. The EU welcomes the opportunity to submit its views on this important issue and looks forward to discussions of the Ad Hoc Working Group on Long-term Cooperative Action under the Convention to elaborate these mechanisms.
4. The development of new market based mechanisms should complement existing Kyoto mechanisms recalling that maintaining a continuing strong role for existing mechanisms is important for broadening carbon markets and maintaining the trust of carbon market investors. Nevertheless, the EU emphasises the importance of further improving the CDM and JI mechanisms through enhancing their effectiveness, efficiency, environmental integrity and governance.

5. This submission should be considered in conjunction with our previous submissions, most recently those of February, March and April 2009[1] and July 2010[2].

Why new market-based mechanisms are needed?

6. Efforts to reduce GHG emissions by developed country Parties alone will not be sufficient to reach the 2°C objective now recognised in the Cancún Agreements. Also substantially enhanced nationally appropriate mitigation actions by other Parties are required.
7. This implies that ambitious emission reduction commitments by developed country Parties (25-40% by 2020) need to be complemented by substantial deviations (by 15-30% by 2020) from currently projected emissions in developing countries, especially more advanced developing countries.
8. Therefore, there is a need for developing nationally appropriate mitigation actions. These can be unilateral, supported through finance, technology and capacity building as well as supported through the sale of emission reduction credits on the market if a certain emission reduction threshold below projected emissions is reached. All three types of nationally appropriate mitigation actions should be available to Parties on a voluntary basis and they should be recognised by being listed in the Registry which was agreed to be established in Cancun.
9. With CDM, JI and International Emissions Trading, market based approaches are already established and applied under the Kyoto Protocol. The Clean Development Mechanism (CDM) has been important in allowing developing countries to participate in the carbon market and providing them with financing for clean technology. In addition, the CDM is helping developed country Parties to comply with their emission reduction targets in a cost-effective manner. However, in order to further enhance mitigation action and to allow Parties to take ambitious targets, the scope and coverage of market-based mechanisms should be broadened. The CDM is a project-based approach, where emission reductions are credited from business-as-usual. Such a project-based system alone cannot be sufficient to pursue low-emission pathways, therefore new market-based mechanisms are needed to allow us to stay within the 2 degrees target.
10. We need new market-based mechanisms:
    - To foster climate investment in developing countries: new market-based mechanisms[3] provide incentives for enhanced mitigation actions and can increase the carbon finance flows.

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1 Contained in FCCC/KP/AWG/2009/MISC.3, FCCC/AWGLCA/2009/MISC.1/Add.4, FCCC/KP/AWG/2009/MISC.9 and FCCC/AWGLCA/2009/MISC.4 (Part I) respectively

2 FCCC/KP/AWG/2010/MISC.5/Add.1

3 By market mechanisms we include all mechanisms that create a price incentive for both sellers and buyers for implementation of GHG emission reductions; typically these involve a regulatory framework which limits the overall rights to emit of participants creating overall scarcity, but allows participants to buy and sell the limited rights to emit within this limit, creating a market price. Typically these mechanisms include emissions trading which generate demand because there is a hard cap on emissions of participants and penalties for failure to meet targets, but these may be supplemented by other mechanisms which generate supply by allowing emissions reductions to be credited on the basis of a baseline or soft or relative cap.

- To enhance cost-effectiveness: use of market mechanisms can enhance the cost effectiveness of mitigation and enable ambitious mitigation action, because such mechanisms incentivise market participants to discover and implement least cost abatement opportunities within their scope of operation. The EU Emissions Trading System has been a key element for the EU and its Member States to reach and advance its emission reduction goals. Other approaches, for example typically direct regulations, are generally not as cost effective as market based mechanisms, provide less flexibility and rely on a greater degree of public enforcement for their implementation.
- To scale up mitigation efforts in all countries: enhanced cost-efficiency facilitates the undertaking of ambitious targets by developed countries and helps developing countries to engage in global actions at a larger scale, which are both needed to be able to reach the 2 degrees target.

Incentives for developing countries

11. New market-based mechanisms could allow a tailor made approach, taking into account the different capabilities of the various countries
12. New market based mechanisms will assist developing countries in attracting additional international financing to allow developing countries to go beyond their own actions in some targeted broad segments of their economy.
13. It will also contribute to enhance their knowledge of MRV of emissions in some segments of their economy, limiting dangerous climate change and be internationally recognised for that.
14. The UN Secretary General's High Level Advisory Group on Climate Change Financing reported last year that US$30 billion to US$50 billion annually could be generated in increased carbon market flows to developing countries, "if and when carbon markets are further developed and deepened". Achieving carbon market flows of this magnitude would rely on ambitious mitigation commitments from developed countries and the introduction of new mechanisms – CDM on its own would not be sufficient.
15. Important capacity building support will also be required to develop and implement new market-based mechanisms. The EU is willing to strengthen its cooperation and support to improve carbon market readiness in developing countries, in particular through piloting actions.

Common rules for new-market based mechanisms

16. Many countries are currently developing ideas for new market-based mechanisms, some of which happen irrespective of the developments at the UNFCCC level. Hence, it is important to ensure that accounting for emissions as well as purchases and sales of emission reductions are consistent with the international accounting framework under the UNFCCC to ensure transparency and comparability of actions.

17. Providing a common framework for new market-based mechanisms can facilitate national implementation and promote access to markets internationally. This common framework can be done either by defining eligibility criteria to participate in these mechanisms (similarly to the International Emissions Trading under the Kyoto Protocol) or by providing common rules for assessment of individual segments of the economy (similarly to the CDM). The framework, while providing common rules, can be tailored to enable a degree of national discretion in implementation as may be appropriate to national circumstances.

Two types of new-market based mechanisms

18. New market-based mechanisms are needed in order to stimulate the reduction of GHG emissions across broad segments of the economy and generate units for the efforts that go beyond pure offsetting in developing countries. With these new market-based mechanisms, developed countries can adopt ambitious mitigation targets, and developing countries can access to the carbon market at a greater scale while also contributing to global mitigation efforts.
19. We distinguish two types of market based approaches covering broad segments of the economy:
    - Crediting: Existing emissions of a broad segment of an economy will be checked against an ex-ante agreed baseline for this segment. If emissions are below this baseline, emission credits will be issued, which can be sold to recover at least partly the cost of mitigation activities. If emissions are not below the baseline, no penalty will be applied (no-lose target).
    - Trading: In accordance with an ex-ante defined absolute target for a broad segment of an economy, emissions allowances will be issued. If emissions are lower than the number of issued allowances, excess allowances can be sold to recover, at least partly, the cost of mitigation activities. If emissions are higher than the number of issued allowances, additional allowances need to be purchased on the global carbon market to comply with the target agreed for the broad segment.
20. Units from both approaches can be used for compliance by any Party with emission targets under the Convention. Under trading, allowances will be issued ex-ante so that they can eventually be sold immediately on the market.

Characteristics of the new-market based mechanisms

The following sections elaborate characteristics from the Cancún decision, which should serve as basis for detailed modalities and procedures. Sufficient time should be dedicated in upcoming meetings to in-depth discussion on each of these characteristics.

- ***Voluntary participation supported by the promotion of fair and equitable access for all Parties***

21. Participation in the market based mechanisms is voluntary. Engaging in new market-based mechanisms would be part of the process to develop nationally appropriate mitigation actions. Similar to other types of nationally appropriate mitigation actions, participation in the new market-based mechanisms would be on a voluntary basis.
22. The use of market mechanisms to deliver mitigation action is a national policy prerogative as is the case with other instruments, and dependant on Parties deciding to implement these mechanisms and putting national measures in place to implement them. Parties are free to implement purely domestic market measures and account for the domestic emission reductions achieved as purely domestic emission reductions – as in the case of national or sub-national emissions trading schemes. The linking of domestic market instruments is also a national policy decision among Parties.
23. In order to ensure fair and equitable access to the new mechanisms, detailed eligibility criteria for participating in new market-based mechanisms should be defined, as it is already the case with existing Kyoto mechanisms.

- ***Complementing other means of support for nationally appropriate mitigation actions by developing country Parties***

24. Market-based mechanisms can be nationally appropriate mitigation actions. When implemented domestically, they may constitute unsupported domestic action to the amount of the emission reductions achieved.
25. When linked internationally, new market-based mechanisms may deliver a significant amount of finance and investment to domestic emission reductions. There should be no double counting of mitigation actions. Any emission reductions achieved through the purchase of emission reduction units will count towards action of those purchasing and not towards the action of the country selling emission reductions4 (see also section on environmental integrity).
26. Design and implementation of new market-based mechanisms will require capacity building support for policy and institutional design, in particular to monitoring, reporting and verification. In this context, it will be important how the action will be supported, because internationally financed actions will require compliance with international MRV requirements.

- ***Stimulating mitigation action across broad segments of the economy***

27. A scaled-up mechanism is necessary to achieve more mitigation, achieve transition towards low carbon economy and to attract more international investment.

[4] The exception is where emission reductions are not purchased and used for compliance purposes.

28. While the CDM is based on project-by-project evaluation of mitigation action, new market-based approaches should cover a broad segment of the economy in order to incentivise mitigation action in all covered activities. This will not only increase the covered mitigation actions, but also reduce transaction costs caused by the assessment of individual projects. The main differences to the existing CDM are that new market-based mechanisms will include all activities of a certain broad segment of an economy and not just individual installations and that the responsibility for achieving the targets will be with the Party rather than with individual owners of mitigation projects.
29. A broad segment of an economy could constitute a significant proportion of a country's emissions (i.e. have large emission reduction potential) and/or constitute a significant proportion of a country's GDP. For example, a broad segment of an economy could be a sector (as in national statistics: power, iron and steel, cement, etc), a sub-sector (as public transport, lighting, etc.) or multiple sectors. When developing the scope of the new market-based mechanisms they want to undertake, developing countries need to consider, where appropriate, context-specific circumstances, as well as responsiveness to carbon price, i.e. whether a price signal gives an incentive to reduce emissions.
30. Project-by-project assessment in the existing mechanisms, where each project must be assessed against what would have happened in the absence of that project, is administratively complex and time-consuming. In developing new mechanisms, we would expect that Parties would mandate emission reductions to be achieved across a range of activities in advance, and that this should reduce the relative complexity and transaction costs associated with assessment. It would also enable national governments to implement nationally appropriate mitigation action much more effectively, and allow them much more discretion in doing so.
31. Host countries would need to consider the role given to the private sector in practical implementation of the mechanisms. The EU would like to highlight the important role of the private sector in identifying cost-efficient and feasible emission reduction opportunities in practical implementation.

- ***Safeguarding environmental integrity***

32. One of the primary conditions for the successful deployment of market mechanisms in the context of ambitious mitigation goals is that these should maintain environmental integrity and they should not lead to perverse outcomes for the environment. While environmental integrity may be defined in many ways, due to the absence of a commonly agreed official definition, we assume the following conditions on the success of market mechanisms:

    - Robust MRV

33. Proper modalities for accounting of emissions and of emission reductions should be established to result in real, additional, measurable, reportable and verifiable emission reductions. This requires a process for setting appropriately ambitious emission reductions, i.e. clearly beyond emission reductions that would have occurred otherwise. It would also require a monitoring, verification and reporting framework, i.e. a process and a mechanism (for example, an emission registry) that accounts for the traceability and comparability of any credits towards emission reduction commitments or goals.

    - Avoiding double counting with financial commitments

34. Financing through the carbon market should be monitored and recognised separately and cannot be counted towards fulfillment of commitments to public financial support, except for procurement of offset credits that are not used for compliance with quantified emission targets.

35. In turn, such requirements presuppose at the start, clarity with relation to the role of domestic policies, a clear definition of the covered activities or segments and availability of crediting in relation to the proposed mechanism. Where domestic emission reduction policies are undertaken without support through international carbon market but with alternative sources of finance (wherever it may come from), it must be clear that the carbon finance component of any mitigation action can only refer to additional measures.

- Avoiding leakage

36. Furthermore, any mechanism to be established should also take into account the potential for displacement of activity and emissions to sectors not covered by the mechanism. This particular concern argues for the widest scope possible for any new mechanism, in its practical applications, but also for modalities to account for leakage emissions.

- Avoiding double counting with existing mechanisms

37. There is a need to have clear rules regarding the relationship between existing and new market-based mechanisms for the orderly transition between mechanisms. These rules should provide clarity to investors, ensure the continuing stability of the market and avoid double counting of emission reductions. In principle, once a new market-based mechanism is applied, no new CDM registration would be eligible in the same sector in the same country, while existing CDM investments need to be honoured

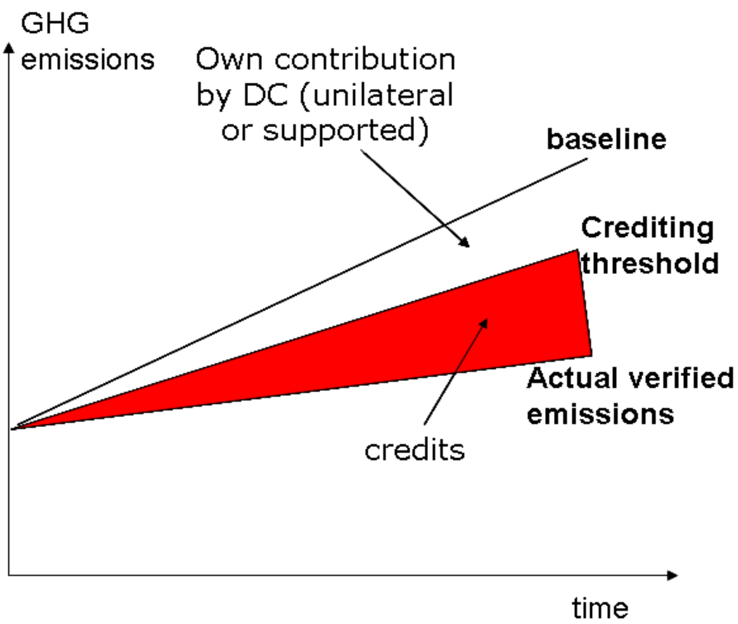
- Consistency with other sustainable development policies.

38. Finally, environmental integrity relates not only to the verifiability of emission reductions, but also to the environmental impacts of the proposed actions. To the extent that these may impact on other goals of sustainable development policy, these must be taken into account in the design of the crediting mechanism with a view of avoiding such impacts. It is not in the interest of the climate regime to conflict with other goals of sustainable development policy. In particular, any commitments pursuant other environmental treaties and conventions should be carefully monitored for possible conflict with the proposed actions under any new mechanism.

- ***Ensuring a net decrease and/or avoidance of global greenhouse gas emissions***

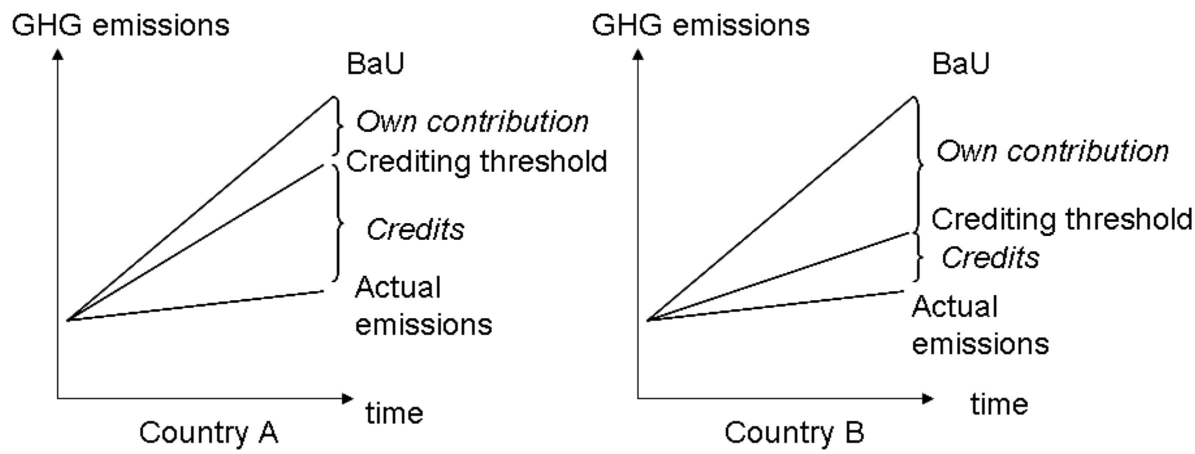
39. In order to ensure net decrease of global GHG emissions, it is essential that new market-based mechanisms credit the emission reductions against ambitious crediting threshold that are below business-as-usual emissions. Emission reductions between business-as-usual (or "do-nothing" scenario) and crediting threshold could be done by developing countries unilaterally or they could also be supported by other means of financing than demand for credits from developed countries. Emission reductions below the crediting threshold generate credits that can be sold on the international carbon market (Figure 1).

Figure 1: Net decrease of global GHG emissions



40. Setting the crediting threshold below business-as-usual emissions ensures that new market-based mechanisms would credit emission reductions towards higher end of cost curve leaving low cost solutions as own contribution to emission reductions by developing countries. Many developing countries are coming up with climate change plans, strategies and various actions. Unilateral, supported or credited, these actions should be properly recognised (figure 2).

Figure 2: recognising own contribution by developing countries



Example: There is a level of trade-off between recognising developing country's contribution to global mitigation action and receiving credits that can be sold on an international carbon market. Country A receives relatively more credits, but has less own contribution recognised, while Country B has relatively less credits, but have more recognition for own contribution.

In principle, stringency of crediting threshold should reflect respective capabilities to undertake appropriate own action by developing countries. In such way, a developing country with a higher capability to undertake appropriate own actions would be expected to set more ambitious crediting threshold than a developing country with a lower capability to undertake appropriate own action, in accordance with the principle of common but differentiated responsibilities and respective capabilities.

41. Some options for setting the crediting thresholds include:
    - Setting the threshold below and in relation to actual and verified emissions collected for x years prior to the start of new market mechanisms;
    - Setting the threshold as a fixed percentage below estimated business-as-usual emissions or a dynamic percentage related to the level of development of a country or a broad segment of economy;
    - Estimating a benchmark related to best available technology or technology used in a reference case at appropriate level (i.e., country, region, global).
42. The crediting thresholds should be periodically reviewed. Alternatively, a system of rolling crediting period of x years with long term trajectory of x years could be explored.

- ***Assisting developed country Parties to meet part of their mitigation targets, while ensuring that the use of such mechanism or mechanisms is supplemental to domestic mitigation efforts***

43. An essential element of any market-based mechanism is creation of a tradable unit, which can be used to comply with emission reduction targets. Nevertheless, new market-based mechanisms will be supplemental to the domestic action by developed countries. This domestic action will constitute a significant part of the effort made by developed countries.
44. For developing countries, in a similar way, some nationally appropriate mitigation actions that they propose will not be linked to the carbon market and thus not generate emission reduction credits. Crediting thresholds should incorporate national policies designed to achieve domestic reductions that will not generate credits to be sold at the international market.

- ***Ensuring good governance and robust market functioning and regulation***

45. Implementation of new market-based mechanisms will require robust governance to ensure credibility, environmental integrity and good functioning of these mechanisms. To create synergies in institutional arrangements and avoid unnecessary procedural duplication, the international governance structure and process for developing countries to propose use of new market mechanisms should complement to the extent possible that for nationally appropriate mitigation actions. . This will need to be complemented with appropriate governance structures in developing countries to coordinate the implementation of national policies to achieve crediting beyond threshold.

46. There are many different ways in which governance for new market-based mechanisms can be designed, e.g.:

- A centralised model in a form of Special Supervisory Board (similar to the CDM Executive Board), which centrally approves methodologies for estimating baseline and emission reductions, oversees the accreditation of verifiers, approves business-as-usual emissions and crediting thresholds, issues credits, maintains the registry, etc.
- A decentralised model in a form of Report and Review, where eligibility criteria are set for granting access by developed countries to the supply of credits/tradable units from the new market-based mechanisms. This would include an expert review team, which assesses if eligibility criteria are met.

47. Whichever governance form is chosen, the following needs to be further elaborated and defined:

- Process for proposing crediting thresholds;
- Framework for reviewing and assessment of crediting thresholds;
- Responsibility for and point of issuance of credits/tradable units (i.e. who issues credits/tradable units and ex-ante/ex-post);
- Criteria/methods for proposing a crediting threshold;
- Definition of boundaries for broad segments of economy;
- Length of the crediting/trading period;
- MRV and accounting framework (see below);
- Financing of the system

MRV and Accounting for new-market based mechanisms

48. A clear MRV and accounting framework needs to be in place to avoid double counting of emissions and ensure comparability of actions. MRV and accounting requirements for new market-based mechanisms have to be coherent with overall framework, but additional level of accuracy is required since a part of emission reductions can be used as offsets.

49. A robust MRV framework implies that emissions are being monitored with sufficient accuracy in all relevant installations in the broad segment of economy5, ensuring that sector boundaries remain the same over time and minimising the risk of carbon leakage. In addition, independent verification of data and proposed crediting thresholds is important.

[5] In practice, this could mean starting with covering rather large installations in each broad segment of economy (e.g. power plants above 300 MW installed capacity) and include smaller installations later on as appropriate. Alternatively, to balance accuracy with MRV efforts, accuracy tiers could be established requiring larger installations to provide more detailed monitoring data than smaller installations.

50. Where units are used for compliance for mitigation targets, there is a need for a system for accounting for those units. Such system should include at least the following elements:

- Units are accounted in tons of CO_2 equivalents
- Sufficient level of ambition for emission reductions is provided.
- Risk of carbon leakage is minimized.
- Double counting is avoided.
- Robustness of the market is ensured.
- (Minimum) requirements for MRV and accounting need to be fulfilled:
    - in developed countries these modalities need to relate to accounting requirements for targets in developed countries
    - in developing countries these modalities need to relate to accounting requirements for actions in developing countries.