

Submission

To: UNFCCC Secretariat
From: Carbon Markets Association
Subject: Second Review of the Kyoto Protocol pursuant to its Article 9.
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The third Conference of the Parties serving as the Meeting of the Parties to the Kyoto Protocol (CMP3) in paragraph 6 (d) of the decision *Scope and content of the second review of the Kyoto Protocol pursuant to its Article 9* invited Parties and relevant organizations to submit their views on:

The scope, effectiveness and functioning of the flexibility mechanisms, including ways and means to enhance an equitable regional distribution of clean development mechanism projects

We welcome this opportunity to submit our views on ways to improve the scope, effectiveness and functioning of afforestation and reforestation (A/R) activities under the CDM with the recognition that doing so will help enhance the regional distribution of CDM projects.

The Failure of the CDM to Support A/R

For a long time the debate on the accounting for the climatic benefits achieved by forests and other ecosystems under the Kyoto Protocol in general, and the CDM in particular, was characterized by the notion that sinks act as a mere distraction from more essential activities to mitigate climate change, such as the switch from fossil-based to renewable energy. In addition, technical issues such as permanence, leakage, measurement uncertainties and monitoring techniques were poorly understood outside a selected group of specialists. These insecurities resulted in an over-emphasis of risks associated with A/R projects by policy makers. The rules and modalities for CDM A/R projects that were established at CP7 in Marrakech in 2001 and at CP9 in Milan in 2003 take note of the various real and perceived risks by formulating a number of restrictions that were designed to limit the use of A/R CERs (i.e. the 1% rule; non-allowance of banking of forestry credits) as well as to address the particular risk profile of forestry projects (i.e. temporary CERs and their expiry at end of crediting period; definitions of forest, reforestation and small-scale projects; monitoring and verification frequency). Motivated by the intent to manage risk, the rules have proven to be so restrictive that they have effectively eliminated forestry and other land-use projects from the CDM. Consequently, the CDM failed to lever additional investment into mitigation activities in the forestry sector.

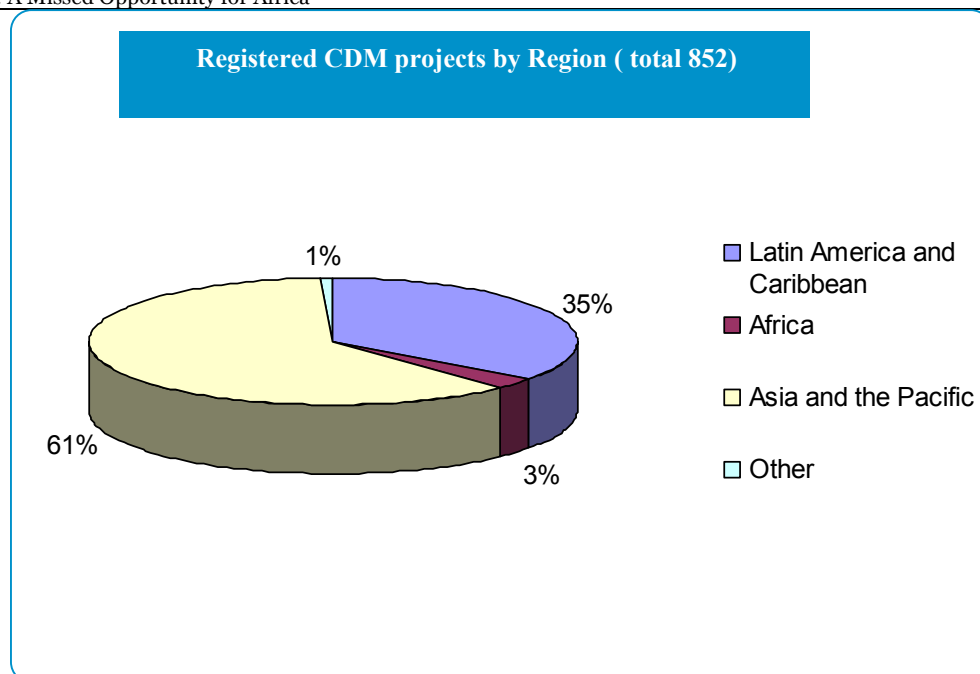
The CDM rules and procedures impose unnecessarily high compliance costs and deprive Africa and the other poorest regions of this World from benefiting from the opportunities provided by

the CDM. (see figure 1). 63% of CDM approved projects are located in the rapidly industrialising countries China, India and Brazil.¹

To date, despite approving some 10 methodologies for A/R projects, the CDM process has resulted in the registration of only one forest project. This project is located in China and is forecast to generate only 327,000 tonnes CO₂e of emission reductions over the first commitment period,² or just 0.27% of the amount allowed even under the Marrakech Accords. Improving the effectiveness and functioning of A/R activities will help the implementation of these activities in Africa and other regions that do not have significant opportunities in other sectors.

Figure 1

CDM: A Missed Opportunity for Africa



Source: <http://cdm.unfccc.int>

A/R Activities as Important Climate Change Mitigation Activities

Things have changed. Today, policy makers realize that the land use sector is one of the key sectors for addressing climate change and adapting to its effects. Not only must emissions from tropical deforestation be halted, but so must the excess amounts of GHG in the atmosphere be removed through enhancement of the terrestrial carbon sink. After all, reducing emissions only

¹<http://cdm.unfccc.int/Statistics/Registration/NumOfRegisteredProjByHostPartiesPieChart.html>

² Project Design Document: “Facilitating Reforestation for Guangxi Watershed Management in Pearl River Basin, China.”

reduces the *increase* of GHG concentrations in the atmosphere. Therefore it is essential that A/R efforts are supported as essential part of the policy mix that addresses climate change. With the words of the IPCC: “*No single policy instrument will ensure the desired transition to a future secure and decarbonized world. Policies will need to be regionally specific and both energy and non-energy co-benefits should be taken into account.*”³

Furthermore, a future international regime or mechanism that rewards the reductions of emissions from deforestation and forest degradation (REDD) cannot be sustainable if the reduced supply of woody biomass (e.g. for timber or fuel wood) as a result of conservation of forests is not addressed through increased tree planting elsewhere. Any discussions on such a REDD regime cannot be taken seriously without also addressing the failure of CDM A/R.

In addition, there is significant potential for A/R activities within least developed countries. CDM project activities in the land-use and forestry sector provide by far the largest opportunity for countries with largely agricultural economies to participate in the CDM.

Therefore unnecessary barriers in the rules and modalities for CDM A/R projects on the use of CDM A/R credits should be removed in order to provide effective incentives for the development of sustainable A/R project activities. Issues that were previously poorly understood and thus contributed to the perception of risk associated with A/R credits, including non-permanence risks and measurement uncertainty, are now much better understood. This should also be reflected in the rules and modalities for CDM A/R projects and existing provisions dealing with crediting, project eligibility and monitoring and verification practices should be altered.

What follows is a discussion of the existing restrictions on A/R projects, including proposals for their improvement.

Modify the Definition of Reforestation

The Annex to Decision 16/CMP.1 *Land use, land-use change and forestry* defines “reforestation” for the purposes of the CDM.⁴ This definition states “For the first commitment period, reforestation activities will be limited to reforestation occurring on those lands that did not contain forest on 31 December 1989.”

This rule was introduced to prevent the perverse incentive of deforestation for the purpose of subsequently planting trees to generate credits under the Kyoto Protocol. Significant deforestation has occurred since 31 December 1989 that is completely unrelated to gaining subsequent carbon sink credits under the Kyoto Protocol. The FAO estimates that annual deforestation since 1990 has run at a rate of 13 million hectares per year, with a net forest loss of 8.9 million hectares per year from 1990-2000, and 7.3 million hectares annually from 2000-

³ Page 255 of the *IPCC Fourth Assessment Report 2007: Mitigation of Climate Change*. Available on the Internet at (<http://www.ipcc.ch/pdf/assessment-report/ar4/wg3/ar4-wg3-chapter4.pdf>).

⁴ See paragraph 1 of the Annex to Decision 5/CMP.1 Modalities and procedures for afforestation and reforestation project activities under the clean development mechanism in the first commitment period of the Kyoto Protocol

2005.⁵ Thus, 125-195 million hectares of deforested land is now ineligible for CDM forestry (an area three times the size of France) and the area is growing (not least because of the lack of any crediting of avoided deforestation and the lack of alternative supply from A/R projects) by an area the size of Greece every year. It is happening in the world's most bio-diverse areas and the home to many of the world's last remaining indigenous forest peoples. The 1990 land eligibility rule arbitrarily prevents efforts to restore vast and important areas degraded or deforested after 1990; reforestation activities on these lands should be eligible under the CDM.

The anxiety as to gaming has been belied by reality. To date not a single example of destroying forest to plant carbon has emerged. To deal with any residual theoretical concern, the objective of preventing incentives to deforest can be maintained and the areas of eligible land can be increased if this part of the definition is changed to read for the purposes of the CDM "Reforestation activities will be limited to reforestation occurring on those lands that did not contain forest 10 years before the project start date."

Remove the Definition of Forest

The CDM A/R modalities differentiate between 'forest' and 'non-forest' land through the use of a forest definition that includes minimum threshold values for tree height, crown cover and size and width of a forest patch. Projects that seek to significantly increase biomass stocks above those in the baseline scenario but that do not comply with the forest definition of the host country are not eligible to participate in the CDM. Specific experiences of CMA members show that there are many such potential projects.

No alternative set of modalities exists for 'non-forest' land-use activities that otherwise comply with all other CDM criteria. Indeed there seems to be no reason why such activities should not follow the same principles as those that do comply with the forest definition (which is after all an arbitrary separation). There seems to be no logical basis for the use of a restrictive forest definition at all. If projects diligently follow approved methodologies that deal with relevant issues such as baselines and measurement certainties, and if they can demonstrate that they will result in net anthropogenic GHG removals by sinks then there should not be any reason to exclude these projects from the CDM. For this reason the requirement for a definition of 'forest' should be abandoned.

Remove Credit Expiration

The Annex to Decision 5/CMP.1 *Modalities and procedures for afforestation and reforestation project activities under the clean development mechanism in the first commitment period of the Kyoto Protocol* (A/R Modalities and Procedures) states in paragraph 23 that the crediting period of A/R projects shall be either 20 years which may be renewable twice, or 30 years which cannot be renewed. This rule fails to acknowledge that forests are a long-term store of carbon. They have covered vast areas of the earth's surface for millennia, and contain 60% of the carbon stored in terrestrial ecosystems.⁶

⁵ FAO, Schoene, Dieter, "Reducing Emissions from Deforestation," Rome 2006, <http://www.fao.org/forestry/webview/media?mediaId=11368&langId=1>

⁶ IPCC, Land use, land-use change, and forestry: a special report of the IPCC. (Cambridge & New York. Cambridge University Press, 2000)

This rule on its own is inherently unreasonable because both tCERs and lCERs generated by a project either cannot be issued after the end of the crediting period (in the case of tCERs), or are cancelled at the end of the crediting period (in the case of lCERs).⁷ As a result, all tCERs and lCERs used by a Party must be ultimately replaced in 20, 30, 40, or 60 years, even if the underlying carbon stock in the registered CDM project is being maintained. This produces two negative results.

1) Perverse incentive to harvest

The project owner is denied any further income associated with its stored carbon once the crediting period expires. Deprived of further carbon revenues, the replacement rule creates the perverse incentive for the project owner to harvest the timber as soon as the project expires under the CDM.

2) Devaluation of CDM A/R credits

The requirement to replace the tCERs or lCERs at some arbitrary point in the future irrespective of project performance means a buyer of the tCERs or lCERs must significantly discount the value of the tCER or lCER. As a result of this discount tCERs and lCERs are given such little value that it is very difficult for the CDM to produce any real financial incentive to implement CDM A/R projects.

This rule should be changed so that credits issued during the crediting period can be continue to be issued or remain valid after the end of the crediting period if the underlying carbon stock is maintained.

Flexible Approach to Dealing with Permanence

The A/R Modalities and Procedures address the risk of permanence by creating temporary credits (tCERs and lCERs).⁸ This approach means CDM A/R credits are fundamentally different to “permanent” CERs and contain significantly more risk associated with credit re-issuance (with tCERs) or re-verification (with lCERs). As a result, the credits are not fungible with other credits and their price is heavily discounted as second rate credits. This steep price discounting means CDM A/R projects gain very little financial incentive from the CDM so are not viable.

There are other approaches to dealing with permanence, such as the pooled buffer approach adopted by the Voluntary Carbon Standard and the Chicago Climate Exchange.⁹ This approach allows issuance of “permanent” credits for A/R credits that are fungible with credits from other sectors. This approach in the CDM would significantly increase value of CDM A/R projects and the appeal of carrying out CDM A/R projects.

Simplify Methodologies

⁷ See paragraphs 42 and 46 of the A/R Modalities and Procedures.

⁸ See parts J and K of the A/R Modalities and Procedures

⁹ See <http://www.v-c-s.org/> and see [cite]

The CDM A/R methodologies are exceedingly complex and expect a significantly more rigorous accounting than is required in other sectors. For example, the A/R methodology AR-AM0001, Version 02 *Reforestation on degraded land* includes accounting for “Leakage due to vehicle use for transportation staff, seedlings, timber and non forest products, as a result of the implementation of the proposed A/R CDM project activity”.

In comparison, *ACM0002 Consolidated baseline methodology for grid-connected electricity generation from renewable sources* states:

“The main emissions potentially giving rise to leakage in the context of electric sector projects are emissions arising due to activities such as power plant construction, fuel handling (extraction, processing, and transport), and land inundation (for hydroelectric projects – see applicability conditions above). Project participants do not need to consider these emission sources as leakage in applying this methodology.”

This clear discrepancy in accounting rigor between sectors needs to be corrected. The CDM Executive Board should produce consolidated A/R methodologies that are significantly simplified and require comparable accounting rigor to other sectors.

Re-define Small-Scale

Another example of discrepancy between the A/R and other sectors that should be corrected is found in the definition of small-scale¹⁰ CDM A/R projects. This specifically states that such projects must be developed by poor people, with ‘poor’ being defined by the host country. This restriction has no relevance to the philosophy that drove the establishment of the small-scale project type, neither in A/R nor in other CDM project activities. Indeed, the definition of small-scale projects in non-LULUCF sectors makes no mention whatsoever of the economic condition of the project developer.

Remove the 5-yearly Verification Rule

The A/R Modalities and Procedures state that a project may decide the timing of the first monitoring and verification of net anthropogenic GHG removals by sinks, but that any subsequent monitoring and verification events must be in 5-yearly intervals. There is no sound reason for the choice of the length of the interval, or a determined interval at all. Assuming that commitment periods will always be 5 years in length and that the expiry and replacement obligations of tCERs are maintained, then it would be necessary to rule that projects should *at least* monitor and verify every 5 years. It is not clear however why not allowing projects to verify more frequently, as long as error margins are acceptable (methodologies deal with this).

Since project implementation costs are heavily front-loaded for A/R projects it is important that projects can improve their cash flow and avoid discounting over time by being able to deliver CERs to buyers more frequently than only once every 5 years. Removing this restriction will thus improve the financial viability of CDM A/R projects.

¹⁰ Such projects are allowed to use simplified methodologies and are subject to simplified modalities.

Remove the 1% Cap in The Use of A/R Credits

The CDM forestry rules cap the use of A/R credits to just 1% of an Annex I's country's annual compliance requirement over the first commitment period; equivalent to an accumulated total of 120MtCO₂ annually. The principal justification for this restriction is that the inclusion of forestry credits in the CDM would “flood” the Kyoto trading system with “cheap credits”. This argument never bore real scrutiny either in theory or in fact. In the first nine months of 2006, A/R projects accounted for just 2.1MtCO₂.¹¹ Annual credit delivery from A/R projects over the entire first commitment period (2008-2012) is forecast to range from 7-14MtCO₂.¹² The 1% rule has clearly had a “chilling effect” on the market, discouraging investment in A/R projects which offer the only meaningful alternative to meeting timber and fuel demand by continued deforestation of natural forests. The 1% cap is an artificial restraint that arbitrarily enhances the perverse incentive of encouraging A/R in the developed world while discouraging it in the developing world. The cap should be removed and credit given for all activities which increase forest cover or reduce deforestation in the developing world. This would help promote a fair, comprehensive and environmentally effective global climate protection regime.

Any future REDD programme needs to go hand in hand with the promotion of reforestation and restoration activities. In any assessment of the need for carbon forestry projects in the developing world it is critical to understand that without them the laws of supply and demand will overwhelm, as they have for decades, all other efforts to address the loss of native forests. Projected world demand for industrial round wood and sawn wood will be met partially by an increase in plantation forestry, particularly in the developed world; the balance of timber supply together with consumption of wood for fuel will, unless A/R carbon offset projects are incentivised, continue to be met through the destruction of native forests. At current rates of exploitation the tropical forests will be largely exhausted by 2050 and will have ceased to be intact eco-systems.¹³

Allow Banking of CDM A/R credits

For the same reasons as the 1% restriction was put in place, buyers of CDM A/R credits were not allowed to bank these credits for use in subsequent commitment periods. There is no objective reason why this restriction should be upheld.

Support Efficient Programme of Activities

One of the most promising prospects for wide spread implementation of A/R project activities is through programs of activities (PoA). PoA rules and procedures for A/R should be designed to minimize transaction costs associated with, for example overly technical and complicated methodologies, and repeated validation or registration.

¹¹ See: World Bank, IETA, “State and Trends of the Carbon Market 2006: Update January 1 – September 30 2006”, October 2006.

¹² Jung, Martina, “The Role of Forestry Sinks in the CDM - Analysing the Effects of Policy Decisions on the Carbon Market”, Hamburg Institute of International Economics, 2003.

¹³ “State of the World’s Forests 2005”, “Global Forest Resource Assessment 2005”, FAO 2006, and SFM research

SUMMARY

Unless the CDM Rules covering forestry are significantly revised mankind will not be able to reach its mid-century goal of climate stabilization at or below 2 degrees C above pre-industrial levels.¹⁴ In the absence of substitute supply from afforestation and reforestation it will be impossible to meet mankind's growing demand for forest products without continuing destruction of existing forests particularly in the tropics and sub-tropics. Continuing with the current rules of the CDM will necessarily exclude the world's poorest countries and people from the carbon markets and deny them a critical component of what they need to adapt to climate change and to move to sustainable rural livelihoods.

¹⁴ Stern, Mckinsey