

## Submission

To: UNFCCC Secretariat  
From: Carbon Markets Association  
**Subject: Second Review of the Kyoto Protocol pursuant to its Article 9.**  
Date: 7 March 2008

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### CMA submission on Article 9 review

The 3rd CMP has invited Parties and relevant organizations to submit their views to the UNFCCC secretariat, by March 2008, on, among others, on

- a) Extending the share of proceeds to assist in meeting the costs of adaptation to joint implementation and emission trading;
- b) Privileges and immunities of individuals serving on constituted bodies established under the Kyoto Protocol; and
- c) the scope, effectiveness and functioning of the flexible mechanisms.

The present submission summarizes the views of the Carbon Market Association (CMA) on the above mentioned subjects.

#### **a) Extending the share of proceeds to assist in meeting the costs of adaptation to joint implementation and emission trading.**

Extending the share of proceeds to Joint Implementation is a viable option so long it is similar to that of CDM; charging a levy when Assigned Amount Units (AAU) are converted into ERUs and issued under JI projects, i.e. at the primary point of creation.

At an international level, government to government Assigned Amount Units (AAU) trading for national compliance purposes could incur a one off charge as the AAUs are transferred. Within this category of trade it may be desirable to have a higher charge for projects that are not linked to a credible and robust Green Investment Scheme.

To put a levy on trading of AAUs used in national or regional emission trading schemes is not desirable. This would ultimately impair liquidity, the economic effectiveness of such schemes and would prove challenging to police.

In terms of national and regional schemes we would encourage the approach taken by the EU. There is a need for the public liability of reducing emissions to be passed down to the private sector through emissions trading schemes. The creation of an integrated global emission trading scheme is desirable to encouraging the reorientation of private investment into abatement opportunities.

A likely outcome of such charges will be to generate political pressure to migrate regional trading schemes out of the Kyoto system. It is worth considering that these schemes could just as easily true up their national credits against AAUs at the end of the compliance period as opposed to trading within the system for the duration of the commitment period. This is an option that is not available for JI, CDM, or national AAU trading.

#### **b) Privileges and immunities of individuals serving on constituted bodies established under the Kyoto Protocol.**

In order to mitigate the risk of the CDM Executive Board or its members being held liable in national courts while at the same time awarding basic procedural rights to affected legal entities, we recommend the establishment of a review process. Such review process would provide Designated Operational Entities (DOEs) and project participants with the ability to appeal decisions of the CDM Executive Board (and the JI Supervisory Board).

Such review process could be adopted by a simple CMP decision. The review body could consist of a small number of individuals nominated by the CMP competent to hear cases on claims alleging the violation of procedural or substantial rules governing the CDM. The review body would adopt rules of procedure that would itemize the formal requirements of submissions and hearings as well as other matters regarding the functioning of the mechanism. The decisions of the appeal process would have to be final. The appellate body would be supported in its activities by the UNFCCC secretariat. Its proceedings as well as the considerations for any judgment would be publicly available.

### **c) Scope, effectiveness and functioning of the flexible mechanisms.**

#### **I. Scope**

Allowing the use of flexible mechanisms is an economically efficient way to ensure compliance with emission reduction targets.

The CDM has so far been very successful. Currently it is expected that it will produce 2.7 billion certified emission reductions (CERs) by 2012.

The first CDM projects provided projects provided the necessary financing for technologies that reduced emissions of non CO<sub>2</sub> gases. Most of these technologies are based on simple end-of-pipe solutions. These projects would have not happened if it was not for the CDM and they were undisputedly additional. Now, as the CDM has successfully targeted low cost reductions by maximising penetration rates for greenhouse gas reducing technologies in some sectors, carbon financing is moving into more challenging abatement opportunities.

Under the current design of the CDM there are sectors which have experienced limited to no benefits, specifically, energy efficiency (EE), transportation (including air and maritime), land use, land use change and forestry (LULUCF), energy demand, sectors of the chemical industry, construction sector, transport, sectors of the metal production industry and solvent use. These sectors are key to any meaningful post-2012 agreement. Certain issues within each sector must be addressed as outlined below. For example:

#### *Energy efficiency (EE)*

EE has a very high potential to achieve low cost emissions reductions, but opportunities under the CDM are currently limited, due to difficulties in proving additionality and burdensome and expensive monitoring requirements. EE instead lends itself to a principle-based approach to additionality in order to reduce administrative burdens. Furthermore, a simple, cost-effective approach for monitoring must be developed.

#### *Transportation*

There are very few approved methodologies for transportation projects under the CDM, and those that have been approved are not widely applicable. The applicability of the current approved methodologies must be expanded and new, widely applicable methodologies must be approved as well. The monitoring of these types of projects, as well as establishing a

reliable baseline, can be very difficult within the transportation sector. Realistic monitoring methodologies must be developed, as well as guidelines for establishing baselines.

*Land use, land use change and forestry (LULUCF)* (Please also see CMA (Forestry) Article 9 Review for a more detailed appraisal).

LULUCF projects have particular merit as a set of project categories, because they achieve great socio-economic and environmental co-benefits. Unfortunately LULUCF projects under CDM have not yet attracted the interest of many carbon credit buyers. The reasons for the lack of success should be subject to discussion with hindsight via a COP-commissioned review process of the reasons for the lack of success of LULUCF under the CDM. In particular, the rules for LULUCF CDM projects regarding the temporary crediting system, project eligibility and methodologies are particularly restrictive.

Another area that suffers from similar problems of baseline establishment, monitoring, and verification is Programmatic CDM. Programmatic CDM could include projects of all of the aforementioned sectors. Programmatic CDM also has the potential to become one of the major success stories of the CDM by taking in smaller activities that more obviously contribute to sustainable development objectives than larger industrial projects. However, in order for Programmatic CDM to become feasible, it is vital that clear guidelines and requirements for additionality monitoring and verification are laid out clearly at the earliest possible opportunity. Some of the problems and possible solutions related to Programmatic CDM projects are outlined below:

#### *Programme of Activities*

Transaction costs: Transaction costs should be reduced, and not shifted from the project design document (PDD) development stage to the validation stage. These costs could be reduced if, for example, additional guidance on the definition of the PoA was available or if proof of additionality would not be required for every CPA.

Avoiding a trial and error approach: For PoAs to be a success, it is important to avoid a trial and error approach at the cost of project developers.

Making more than one approved methodology applicable under a PoA: Typical energy efficiency programmes often include the implementation of different actions requiring the application of several methodologies. Therefore, project developers should be allowed to use more than one approved methodology in a PoA so as to not limit possibilities for maximum emission reductions at individual project sites.

Help defining CPAs: Additional guidance on how to define CPAs would narrow down the applicability of methodologies and would help to ensure fair distribution of transaction costs.

Increased responsibility of DOEs: Validators and verifiers bear a comparatively high risk because experience and standards with PoA are lacking, PoA emission reduction volumes may be large, and monitoring (even based on sampling) will be challenging. These risks can also be passed on to project developers and can result in higher costs for validation and verification.

Definition of CPAs: The definition of the CPA should be broad enough to include all possible project activities that one would like to implement under a defined programme, including different technologies, but specific enough to ensure that the EB can clearly differentiate between two PoAs.

#### *Additionality Test*

One of the main constraints around CDM projects comes from the way in which additionality has been defined. The system has to evolve from the current use of project additionality, to an emission reduction additionality approach.

Additionality is a fundamental principle, but needs to be revisited if carbon finance is to be the catalyst for reaching the scale of emissions reductions necessary for stabilising greenhouse gas concentrations at a level that would prevent dangerous anthropogenic interference with the climate system.

Based on the current experience of implementing projects and the trends in the review of projects by the CDM Executive Board it is clear that project additionality is highly subjective and does not encourage the development of a framework for rational assessment. For example based on the experience of financing projects in the energy sector it is clear that financial additionality would rarely be the driving reason for inclusion of energy projects in the CDM.

#### *Ways for innovation*

a) For carbon markets to act as a catalyst for structural change, we strongly recommend a move towards **standardised baseline approach**, i.e. benchmarks (sector, programme baselines, etc.). Transparently set, reliable baselines that are below business as usual for specific sectors can provide emission additionality, helping overcome the current constraints and difficulty of ensuring project additionality.

The introduction of credible standardised baselines would simply require entities implementing projects to demonstrate that emission reductions are occurring below the set baseline. This will ensure environmental integrity and clarity on how to guarantee additionality of emission reductions, without the need for project specific additionality test per se.

b) In the short term, the CDM Executive Board can help this process by introducing and encouraging the development of more **dynamic baselines** (all of which is within the scope of the Marrakesh Accords) for specific methodologies.<sup>1</sup> This approach ensures environmental integrity as it takes technology penetration into account when determining baselines.

Approved methodology ACM0013 foresees the implementation of a dynamic approach to baseline setting. This provides investors with clarity and rewards early movers but moves the baseline in relation to technology penetration in a given geographic region or sector. This will also contribute to improve data availability in some sectors as it requires project proponents to take the average emissions of similar project activities in previous years.

The concept behind dynamic baselines must be a fundamental pillar in the design and evolution of flexible mechanisms. Standardised baselines should be set in a transparent way allowing for adjustment in relation to technology penetration.

#### *Principle-based CDM*

Principle based CDM involves the pre assumption of additionality for a given activity, for a given period, in a given region.

The investigation of a principle-based approach to CDM could be very beneficial to broaden the technological and geographic scope of the CDM.

A principle-based approach could be particularly useful for advancing the status of PoAs. Furthermore, it could help to reduce the administrative and financial barriers for regions whose level of participation it would be desirable to enhance.

With a view to facilitating broader geographic participation, PoA and principle-based approaches, coupled with further streamlining procedures and reduction of overhead costs for

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<sup>1</sup> See Decision 1/CMP.1 paragraph 48 (c)

regions with particularly low numbers of projects, could play a central role in bringing in countries with low to no CDM uptake into the system.

## **II. Effectiveness**

Project delays damage the financial viability of CDM projects, and reduce the range of project options that are economically viable. However, there is a general lack of awareness amongst regulators about this.

A delay of just one EB meeting can result in up to a 3% CER loss for an individual project, and projects have frequently been delayed for 2 meetings or longer. Some of the projects that have been subject to these delays have subsequently been registered or issued with no changes. Such delays result in losses with regards to both opportunity costs and real costs to CDM project developers. The aforementioned delays are a direct result of the fact that the EB convenes meetings only 8 times a year.

While it is clear that reviews are needed to ensure the environmental integrity of the system, the length of the delays this causes could be substantially reduced by having a full time Secretariat and Executive Board. This would allow them to continually process the CDM project pipeline and to manage associated regulatory activities. For instance, a process that can currently take 3 meetings, delaying a project by 4.5 months, could be expedited if a full time staff was available to consider project issues more frequently.

In addition, 90% of EB meeting time is in closed sessions. Understanding the rationale behind decisions and effective learning is difficult for all stakeholders in the carbon market; this is aggravated when the decisions that affect these stakeholders are made behind closed doors. Open debates and discussions about, for example, the tool for demonstration and assessment of additionality, are needed to understand the ever-changing trends of the CDM.

The accreditation of designated operational entities (DOEs) should also become more stringent than the existing review procedures. A DOE can currently become accredited from a single site visit, but is subject to three supervised visits if it is found that they have made an error. This has a domino effect of further tightening the DOE capacity bottleneck. It would be far better if the DOE accreditation procedures were tighter from the outset, thereby reducing the need for accreditation reviews.

Validation, Verification, and Monitoring (VVM) guidance is another important issue related to the effectiveness of the CDM. Currently VVM is heavily delayed and too slow going. There is a need for early participation and clear guidance on verification (scope, criteria and materiality) to avoid new bottlenecks, request for reviews and further delays with regards to the issuance of CERs.

Role and responsibilities. There is confusion on the exact role and responsibility of the different participants in the system (Designated Operational Entities, Panels, Teams, Working Groups, Project Participants, Experts, Secretariat, etc). An in-depth analysis of the role and responsibilities will shed light into ways on how to improve the overall functionality of the system.

Adequate support structure and remuneration for Executive Board Members.

Avoiding conflict of interest situation. The interpretation of conflict of interests should go beyond the confirmation of the absence of financial interests in a project activity and recognize and avoid the political conflict of interest situation of many Members of the Executive Board that act at the same time as lead UNFCCC negotiators or head of their respective DNA.

## **III. Functioning**

The correct functioning of the CDM hinges on the continued formalisation of procedures and rules by the UNFCCC and Executive Board (EB).

There is need for the creation of a direct channel of communication to ensure due process and address concerns. As a regulator of a market, there is a clear need for further facilitation and formalization of regular, direct interaction between the EB and those who have to apply the rules, namely project developers. The formalisation of the role of the proposed Project Developers Forum (PDF) would go a considerable distance to achieving this end. The creation of the project developers forum would help in the exchange of experiences, sharing of concerns, and act to bring together methodological ideas and provide a better understanding of the various perspectives. This will help achieve greater transparency and information flow in the system.

Providing rationale for decisions. While we acknowledge the institution of a catalogue of decisions and a growing trend to substantiate CDM Executive Board decisions'. It is also acknowledge that many decisions of the CDM Executive Board are debated and agreed behind closed doors. This impairs true transparency and predictability in the system. When the EB makes decisions, there is still the need for a greater consistency of decision making and greater transparency as to the reasons behind decisions that are inconsistent with past practise.

Adoption of administrative procedures and rules for the CDM Executive Board as well as for its supportive structure. For example, currently completeness checks by the Secretariat are taking between 4 and 6 weeks before the 8 week request for registration process can be initiated. Clear and enforceable response times are essential elements of an effective system.

Part of the distance to achieving this could be covered by decisions being made in the context of past decisions. In effect, this would mean the establishment of case law treatment. Such treatment would not only produce a more predictable environment for project developers, but it would also aide the EB in making decisions. Additionally, it would be fairer and more equitable to the recipients of said decisions than the current opaque process.

Another issue which demonstrates the aforementioned need for a full time professional EB and UNFCCC Secretariat is the Review Process. Requests for review by the EB have become common practice, and the standard EB response to requests for registration or issuance. The majority of these reviews produce no changes, or at best are essentially related to the aesthetics of a PDD. This can cost a project 1-3 months in delays, often in the context of a project where there is no need for any change.

The reason for the 1-3 month delay is purely due to the infrequency with which the EB meets. Decisions about projects often only take a matter of minutes. If the EB members were full time, the delays could be greatly reduced by removing the significant gaps (often up to 6 weeks) between EB meetings, whilst concurrently allowing more time for due consideration of projects. Currently, due to the time constraints imposed by having a part-time EB, consideration of projects can sometimes seem rushed and arbitrary, even if the decisions have taken 3 months to be made.