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Implementing the Bali Action Plan:

What Role for the CDM?[1]

by Benito Müller[2] and Prodipto Ghosh[3]

Executive Summary

The Bali Action Plan (BAP) envisages enhanced "measurable, reportable, and verifiable" (MRV) developing country mitigation actions "supported and enabled by" MRV technology, financing and technology building from developed countries. Finding an acceptable operationalisation of this North/South relation will be key to a success of the BAP. The authors suggest that one way of doing so could involve using the Clean Development Mechanism (CDM) as an instrument for establishing direct 'enabling links' between MRV mitigation activities in developing countries and MRV finance from developed countries. In order to adapt the CDM for this purpose – and for this purpose alone (i.e. not for its traditional offsetting use) – the authors propose that developed countries take on obligations to obtain a certain number of CDM credits (CERs) to be retired (and not used as offsets against developed country mitigation commitments). As such, these Retirement-CER Obligations would, in essence, constitute an obligation to enable, through provision of finance, MRV mitigation actions in developing countries in conformity with the BAP. As such they would be separate from the mitigation commitments concerning developed country emissions. They would also be separate from MRV commitments in respect of technology transfer and capacity building, also required under the BAP.

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[2] Director Energy & Environment, *Oxford Institute for Energy Studies*. E-mail: benito.mueller@philosophy.ox.ac.uk

[3] Distinguished Fellow, *The Energy and Resources Institute* (TERI), New Delhi.

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General Considerations

The Bali Action Plan – adopted as Decision 1/CMP.3 during the recent UN Climate Change Conference in Bali/Indonesia – contains a decision to launch a process to reach an agreement by December 2009 on, among other things, enhanced national/international mitigation actions, considering, *inter alia*

> (*) *Nationally appropriate mitigation actions by developing country Parties in the context of sustainable development, supported and enabled by technology, financing and capacity-building, in a measurable, reportable and verifiable manner.*[1]

Although some people still worry about potential ambiguities with regard to what exactly is meant to be *measurable, reportable, and verifiable* (MRV) according to this paragraph, the G77 and China statements during the final plenary at Bali clarified that the triple adjective is meant to apply *both* to the mitigation actions by developing countries, *and* the developed country support through finance, technology transfer, and capacity building of these mitigation actions. In some crucial respects, this paragraph therefore can and must be seen as an evolution of Article 4.7 of the Convention,[2] in the sense that it makes developing country climate change actions conditional on, among other things, developed country payments (for agreed full incremental costs).

What is not quite so clear is how this MRV support and enablement of the MRV mitigation actions is meant to happen? There are a number of ways in which this North-South relation could be operationalised. For example, it could be a relation at the level of individual activities (projects): MRV projects would be directly supported by MRV finance, technology and capacity building. Or the support could be at an aggregate level, say in terms of some form of budget support, particularly for capacity building (as this may be more efficient than capacity building on a mitigation project by project basis). No doubt, considerable effort will be put into elaborating this relation in the months running up to the Copenhagen UN climate conference in December 2009. This paper is simply meant to consider the potential of the CDM – in whichever form (project-based, programmatic, sectoral) – to be used as one among possibly several instruments to implement the relationship envisaged in the BAP in respect of the provision of finance.[3]

CDM as implementing tool for paragraph 1.b.ii: Pros and Cons

The idea of using the CDM as a tool for future mitigation action in developing countries (in compliance with Article 4.7) has been mooted long before the advent of the Bali Action Plan. Ambassador Chandrashekar Dasgupta (former chief climate change negotiator for India), for one, expressed some time ago the view that "it is essential to raise the Clean Development Mechanism from a project-based level to a sector- or programme-based level. This holds the key to success for a second commitment period under the Kyoto Protocol."[4]

In order to establish the sort of relation envisaged in paragraph 1.b.ii of the Bali Action Plan, the CDM would have to deliver nationally appropriate MRV mitigation actions in the context of sustainable development by developing countries, supported and enabled by MRV technology transfer, financing and capacity building. Can it do this?

DC Acceptance. Notwithstanding some of the reservations that have been raised concerning its current implementation, the idea behind the CDM has been precisely that of delivering nationally appropriate MRV mitigation actions in the context of sustainable development. Moreover, the CDM has one key advantage as concerns the implementation of the BAP, namely its general acceptance by developing countries. One has to realise that the North-South relationship stipulated in 1.b.ii has the potential for serious sovereignty concerns, depending on the nature of the envisaged 'enabling and supporting' relationship. As witnessed in the UNFCCC workshop on what has become known as the 'Russian Proposal,'[5] many developing countries are very concerned, not to say suspicious about seemingly innocuous proposals regarding the mitigation of developing country emissions being used to force them into taking on binding commitments. This is why it is crucial for 1.b.ii implementing tools to be accepted by developing countries.

Carbon Market Finance. As concerns the developed country side of the MRV relation, the CDM has the added advantage of a well-defined (project-related) MRV financing model,[6] based on the carbon market, where the size of the financing depends not (only) on the incremental mitigation costs for the actions in question, but on the amount of emissions mitigated, and on the prevailing price of carbon. The fact that this model goes beyond incurred incremental cost coverage by allowing (potential) carbon market profits is key to the attractiveness of the CDM to the private sector.

The TT and CB Problem. At the same time there are also certain aspects of the CDM which are problematic for its use as an instrument to implement the BAP. On the one hand, the CDM has thus far not been particularly effective in providing the other two components of the developed country MRV activities, namely technology transfer and capacity building.

The Offset Problem. The CDM also faces a problem with respect to the MRV mitigation actions (by developing countries), due to the fact that ordinarily, CDM mitigation actions generate offsets used to cover emissions elsewhere. This is problematic because it can be argued that it goes against the spirit, if not the letter, of the (*) reference to "mitigation actions by developing countries": while there is no question about CDM activities being *in* developing countries, it can be argued that the (*) reference is meant to refer to activities which, apart from being carried out in developing countries, also contribute to limiting/reducing from baseline overall global emissions. This is not guaranteed if the generated CERs are used as offsets by developed country Parties.

The Core Model

Is it possible to overcome these problems without endangering the key features in favour of a use of the CDM in this context? As concerns the failure to deliver on technology transfer and capacity building, it can be argued that this should not really be held against the CDM *qua* instrument for implementing the BAP, provided that it is not regarded as the only way of doing so. Indeed, it would arguably not be reasonable to expect a project-based instrument to deliver all three of the developed country MRV constituents (finance, technology transfer and capacity building), particularly not with each and every project.

However, the issue of generally failing to reduce/limit global emission is a problem for the CDM as BAP instrument. But it can be overcome. One could, for example, simply not issue any CERs in the first place. Yet while overcoming the offset problem, this would also exclude a carbon market financing

model. And while one could move to an incremental cost based model by directly reimbursing the incremental costs of the mitigation actions, this could be an additional instrument, not exclusive of the use of CDM as a BAP instrument.

However, there is a way to overcome the offset problem without undermining the desirable features of the CDM, namely by 'retiring' (taking out of circulation) issued CERs once they are in a relevant (developed country) account. In other words, under this model, if a tonne of carbon dioxide emissions is

(i) reduced through a registered CDM project,
(ii) is certified (by a Designated Operational Entity), and
(iii) if the CER issued is retired from a developed country account,

then it would be *deemed an MRV action pursuant to* the BAP.[7]

One of the advantages of this use of the CDM is that, by retiring the generated CERs, the scheme manages to counter at least two of the reasons that are often put forward in defence of the additionality requirement under the CDM, namely (a) to safeguard environmental integrity and (b) to safeguard the price of carbon from a collapse due to a surplus of supply of CERs. This means that one may wish to consider waiving the additionality condition for CDM projects which are used solely for purpose of generating '*Retirement CERs*' (R-CERs). This could considerably reduce transaction costs, and thus may create incentives for developed country actors to engage in the bilateral generation of such R-CERs, as opposed to their generation in unilateral projects, particularly if the scheme has a mandatory element to it (see below).

Variations

There are, as indicated already, a number of aspects of this 'core model' that could be varied in using the CDM to implement (*). For one, there is the issue of whether the retirement of R-CERs would be voluntary or under some form of obligation.

A scheme based on voluntary retirements of R-CERs would obviously be politically less problematic than a mandatory one, but it is not clear how the private sector could be incentivised to participate in such a scheme, and it is doubtful whether left to the country legislatures, public funding would be forthcoming to retire sufficiently many CERs to have a real impact on global emissions.

A mandatory scheme, based on some form of *Retirement CER Obligations* ('R-CEROs') taken on by developed countries − while politically more difficult − could overcome this problem, for it would be possible to pass on the obligation to sub-national entities. For example, anyone subject to a domestic cap and trade regime could be assigned R-CEROs in proportion to their permitted emissions, say as a percentage of allocated emission caps, or as a percentage of emission permits acquired at auctions. However, imposing such obligations creates its own problems.

Demand-side obligations are only fair if they can be fulfilled, which means, in particular if there is sufficient supply (of R-CERs). Moreover, fair obligations must not be excessive, which in this context would be an excessive deviation from the expected incremental mitigation costs. These are two reasons why the introduction of R-CEROs may have to be coupled with some sort of safety valve, making it possible to fulfil ones obligations even if the supply of R-CERs is insufficient to meet the R-CERO

demand directly. One way of doing so would be to allow for an exchange of R-CEROs for cancelling Assigned Amount Units (AAUs) on a 1:1 basis, i.e. an exchange for additional national (developed country) mitigation commitments. This would, in effect, introduce an endogenous price cap on R-CERs determined by the 'regular' carbon price of the regime. Unlike an exogenous price-cap, this approach would not compromise the environmental integrity of the regime.

There are other aspects of the basic idea of retiring CERs to implement the BAP apart from the retirement type (voluntary versus mandatory) that could be modified. One might, for one, wish to encourage the retirement of CERs from certain types of activities, say on the grounds of their desirability with respect to sustainable development, technology transfer, and/or capacity building. This, in turn, could be achieved by way of special incentives, such as subsidies or a restriction of the above-mentioned waiver of the additionality condition.

Alternatively, conditions with regards to technology transfer and capacity building which CDM activities would have to satisfy in order to be counted as being supported and enabled by MRV financing, technology and capacity could be specified, either generally, or left to the discretion of host countries.

Conclusions

Its general acceptance as tool for mitigating emissions in developing countries and its financing model make the CDM an ideal candidate for implementing the MRV (supported and enabled) mitigation actions by developing countries referred to in Paragraph 1.b.ii of the Bali Action Plan, *provided that the generated CERs are retired from developed country accounts and not used as offsets for developed country compliance.* In order to generate significant emission reductions in developing countries, developed countries may have to take on R-CER *Obligations* (R-CEROs) as part of their commitments. While this is not meant to replace 'ordinary' CDM offset activities, and while the CDM is not meant to be the only tool for implementing the Bali Action Plan developing country mitigation activities, CDM BAP activities have the potential of playing a major role in both respects.

Endnotes

[1] Para. 1.b.ii, 1/CMP.3

[2] *The extent to which developing country Parties will effectively implement their commitments under the Convention will depend on the effective implementation by developed country Parties of their commitments under the Convention related to financial resources and transfer of technology, …*

[3] To be absolutely clear: the issue here is *not* to define a new version of the CDM, but it is whether the CDM, in whatever shape or form it will emerge from the present negotiations, could be used as a tool to implement the Bali Action Plan. Moreover, the suggestion is *not* that the CDM should be the only way of implementing para. 1.b.ii, but (if at all) merely one of many ways.

[4] Chandrashekhar Dasgupta (2007). "Mitigating Climate Change – The Role of Developing Countries", Keynote Address to the Conference on The Evolving Climate Regime, Graduate Institute of International Studies, Geneva, 18 January.

[5] See Bonn 2007: *Russian Proposals, Policy CDM, and 'CER Put Options' (CERPOs)* Oxford Institute for Energy Studies, Energy and Environment Comment, July 2007 (available at www.OxfordClimatePolicy.org)

[6] Note that this is a significant advantage, because it pre-empts the otherwise inevitable debate of what level MRV financing should be, to be counted as supporting and enabling according to 1.b.ii.

[7] Note again that this is only meant to be one of many possible ways in which such MRV actions could be carried out.