



Facilitator of the Subsidiary Body Scientific and Technological Advice

c/o: UNFCCC Secretariat
Martin-Luther-King-Strasse 8
D 53153 Bonn
Germany

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Subject **Inputs to SBSTA on considerations of the issue of materiality, as referred to in document FCCC/KP/CMP/2010/L.8, paragraph 31**

UNDP thanks the CMP for the opportunity to comment on this key issue in 2011.

UNDP strongly supports the implementation of the Clean Development Mechanism (CDM), in particular paragraph 2 of Article 12 of the Kyoto Protocol: “The purpose of the [CDM] shall be to assist [non-Annex I] Parties in achieving sustainable development...” Social and economic development and poverty eradication are legitimately the first and overriding priorities of developing country Parties.

The CDM has demonstrated unequivocally that it can be an effective tool to rapidly scale-up and leverage private sector investment toward sustainable development goals of host countries. Nonetheless, there are clearly areas that need improvement, notably the uneven regional and sectoral distribution of CDM. There are many barriers to investment in developing countries, such as sovereign risk, lack of institutional or human capacity, infrastructure shortcomings etcetera, that the CDM cannot reasonably be expected to address. However, one of the key barriers to CDM uptake that *can* be addressed via adoption of materiality concepts, is the transaction costs of the CDM.

Since 2008, the Executive Board has successively tightened rules, and via Secretariat and DOEs, increased the fastidiousness of rule application in an attempt to improve the perceived lack of environmental integrity that had been widely discussed in the press. This approach did for some time improve perceptions, though these gains were scuppered by the more recent controversy associated with the dominance of HFC projects in the CDM.

For practitioners in developing countries the (presumably unintended) consequence of this strategy was to greatly increase project documentation complexity and process times. Currently, transaction costs and times, particularly for unusual, unique or first-of-a-kind projects, can easily surpass \$100,000 and well over a year, just to reach registration. This presents a clear and formidable barrier, particularly for development-oriented, community-based, or LDC-hosted projects. Transaction costs in UNFCCC Secretariat have also increased.

Moreover, as amply demonstrated by the World Bank's *10 years of Experience in Carbon Finance* report of 2010¹, the increased complexity of procedures, and the pedantic application of meticulous rules has delivered **no significant improvement** in environmental integrity of the CDM. While perceptions may have improved somewhat, reality remained largely unchanged, except for increasing transaction costs and times, and hindering access for the poorest.

The judicious application of materiality can go some way to removing or at least reducing this barrier to investment in mitigation and sustainable development.

Utilising established experience: It should be recognised that materiality and the associated concept of 'level of assurance' are well established and familiar concepts in environmental auditing, as well as product and service certification, which have in turn been adopted from financial auditing. Without incorporating materiality, CDM is simply not operating at best practice. These concepts do not need to be re-invented by SBSTA, EB or UNFCCC. There is ample precedent, and indeed, **decades of experience** in the application of materiality within the very DOEs that the EB Accreditation Panel oversees.

The adoption of materiality seems to raise fears that somehow environmental integrity will be eroded. This fear is unfounded and misplaced. Why should projects in developing countries be measured to a much higher standard than the national inventories that Annex I countries use to determine whether or not they meet their Kyoto targets? Implementation of materiality need not be a cause for concern – rather, it is bringing CDM to modern professional standards. There should rather be concern that the CDM is being governed without utilising the benefits of well-proven tools that can improve efficiency and uptake (ie: materiality).

UNDP respectfully suggests that SBSTA work with the organisations with most experience with materiality, notably the ISO and the broader auditing community such as through IASB². Pragmatic implementation will also benefit from consultation with key stakeholders, particularly DOEs and project proponents (or their associations such as IETA, CMIA, and PD Forum). Additional consultation and lessons can also be learned from the Gold Standard's³ implementation of materiality in both CDM and voluntary Gold Standard certification procedures.

Thresholds of materiality: To further reduce transaction costs and direct resources toward mitigation and development rather than processes, materiality in the CDM should be harmonised with the most relevant schemes, namely the EU ETS and JI. These schemes have materiality thresholds of respectively 5% for the verification at installations with annual emissions smaller than 500ktCO₂e and 2% for installations with annual emissions of more than 500ktCO₂e; and 5% for projects with emission reductions of less than 100ktCO₂e and 2% for all other activities.

A straightforward harmonised adoption would suggest a materiality threshold of 5% for Small Scale projects (and VSSC as applicable), and 2% for all other projects. It should be noted

¹ See <http://www.worldbank.org/reference/>

² See <http://www.ifrs.org/Home.htm>

³ See <http://www.cdmgoldstandard.org/index.php>

that these thresholds are in the range or lower than comparable carbon market applications, and lower than several national programmes and the oft used 10% threshold in environmental auditing. In other words, harmonising with the schemes most relevant to CDM is still conservative within the broader context of carbon markets.

Scope of application: The scope of application of materiality and level of assurance should be comprehensive. That is, it should be applied at validation and verification, and should be applied primarily by DOEs – that is – DOEs are given the professional responsibility to define which issues are material, and which are not. It should be recognised that this responsibility is already exercised by DOEs in other streams of their businesses (environmental auditing, product certification etc). In addition, the principles of materiality should be applied by any UNFCCC Secretariat staff, outsourced technical reviewers or EB members involved in project assessments. Further, an understanding and appreciation of the concepts should be embedded throughout the CDM, including in methodologies and processes in order to maximise CDM process efficiency. Recognising that implementation may need to be phased, the first phase should be associated with DOEs and CER issuance.

The CDM has shown it can be effective and deliver sustainable development, but for it to remain relevant in the future, and expand to new countries and new sectors, it must be substantially reformed to improve efficiency. The CDM should be accessible to the poorest and most vulnerable and UNDP believes that the inclusion of materiality in CDM is an important linkage that should be included in any outcome document from COP17/CMP7 in Durban.

UNDP would be happy to provide further elaboration on any of these points or related subjects as desired.