**Subject: IETA response to the AWG-LCA call for input regarding new market-based mechanisms**

21 February 2011
UNFCCC Secretariat
Martin-Luther-King-Strasse 8
D 53153 Bonn
Germany

Dear Mr. Reifsnyder,

I am writing to you in response to the invitation in the ***Outcome of the work of the Ad Hoc Working Group on Long-Term Cooperative Action under the Convention (***-/CMP.16***)*** for Parties and observer organizations to makes submissions on new market-based mechanisms.

In the attached detailed submission, IETA puts forward proposals for two new market-based mechanisms.

### (1) A NAMAs Crediting Mechanism

IETA recommends the establishment of a new crediting mechanism for crediting NAMAs that entail a large-scale activity or set of activities within one of the following three categories:

1. **Benchmark Crediting:** Generates emission reduction credits at the project-level based on benchmarks defined as a target level of performance of a given activity, expressed in tons of $CO_2e$ per unit output, and based on the current performance of a clearly defined population.
2. **Policy Crediting:** Generates emission reduction credits at the national or regional level based on highly standardized, country-specific methodologies that calculate conservative crediting amounts for the implementation of common policy structures (such as, feed-in tariffs) and that incentivize the widespread diffusion of clean energy and other low-emission technologies.
3. **Aggregate Crediting**: Generates emission reduction credits at a pre-defined sectoral or sub-sectoral level by establishing an aggregate baseline based partly on historic performance.

### (2) A Credit Conversion Mechanism

IETA recommends the establishment of a new mechanism to convert environmental commodity credits of diverse denominations into internationally fungible credits. This mechanism will convert units of a different denomination (MWh, e.g.) into metric tonnes and thereby certify them for international transfer. Certified emission reduction credits could be issued for countries that develop new domestic environmental commodity trading systems or increase the ambition of their already-existent systems.

IETA greatly appreciates the opportunity to provide our input on this issue. Please do not hesitate to contact myself or Kim Carnahan, at carnahan@ieta.org, if you have questions regarding this submission.

Sincerely,

Henry Derwent
President and CEO, IETA



**Geneva**
24 rue Merle d'Aubigné
1207 Geneva, Switzerland
Tel: +41.22.737.05.00

**Washington**
1730 Rhode Island Ave. NW
Washington, DC 20036, USA
Tel: +1.202.629.5980

**Brussels**
Boite 27, Rue de la Loi 235
1040 Brussels, Belgium
Tel: +32 (0)22.30.11.60

**Toronto**
100 King St. West, Suite 5700
Toronto, Ontario M5X 1C7, Canada
Tel: +1.416.913.0135

**IETA response to the call for input to the AWG-LCA at CMP16 regarding new market-based mechanisms**

## Introduction

As an organization strongly supportive of the development of global carbon markets as a means to efficiently, effectively achieve emission reductions, IETA applauds the work of the AWG-LCA as it moves to expand the reach of market-based mechanisms. The economic benefits of offering as wide a set of options as possible for mitigation have been modeled, measured and emphasized again and again by experts and commentators, including the IPCC.

IETA takes "market-based mechanisms" to mean institutional structures, voluntary or obligatory, that will make use of market principles to generate or collect funds and distribute them for mitigation and/or adaptation purposes. A common currency of tradable credits—e.g. AAUs, CERs, or ERUs— is used to facilitate comparison and exchange of the effectiveness of different types of activities. The Kyoto mechanisms— emissions trading, CDM and JI—are market-based mechanisms in that sense, with the common currency denominated in $CO_2$ equivalent emission reductions. It is not essential that the tradable credits are denominated as $CO_2e$, however, or that they be "offset credits" in the traditional use of the term.

The Parties have accepted that addressing climate change requires major mitigation and adaptation actions on the part of developed and developing countries alike. Indeed, many developing countries are already moving quickly towards the establishment of robust domestic policies and regulations to reduce emissions and energy consumption; several have already openly embraced the use of market-based mechanisms as they do so. Others have put forward strong proposals for Nationally Appropriate Mitigation Actions (NAMAs) they commit to undertake upon the provision of external support.

The variations in regulatory, economic, and political structures across these countries have and will continue to lead them to choose diverse combinations of policies and activities to reduce emissions and achieve other ancillary benefits. Some have decided to explore the development of domestic CO2e emission trading systems or energy efficiency and renewable energy credit (REC) trading systems. Others have chosen to stick to a project-by-project or programme-level approach or to focus on energy and other regulatory reform. These activities all have three things in common. They require funding sources, finance options, and increasing levels of institutional infrastructure for the measuring and reporting of emissions.

In this sense, IETA uses the term *funding to* refer to the generation of money—or, more precisely, the generation of the incentive to expend money— for a particular activity. In the context of emissions trading, the amount of *funding* available is akin to the *demand* allowances or carbon credits, which is directly related to the stringency of emissions caps. *Finance*, on the other hand, refers to the structures available to put that funding to use and to leverage it into more funding, where necessary, in the sense of creating borrowing structures and/or blending different funding streams together. It should be noted that the more funds they aim to deploy and finance they aim to access, the more advanced the emissions monitoring and reporting infrastructure needs to be. IETA expands a bit more on the need for enhanced monitoring and emissions reporting infrastructure in the *Principles* section of this submission, though much more could and should be said.

As the need for additional funding sources and finance options for scaled-up emission reductions is met, IETA believes that new market-based mechanisms will be needed draw private finance to emission redution activity and to ensure that environmentally strong emission reductions can be made with the most economic efficiency. These new mechanisms can and should be designed to accommodate as many of the tools and activities that developing countries have chosen for themselves and proposed as NAMAs through the UNFCCC as possible. Participation in these mechanisms will, of course, be entirely voluntary. It should also be noted that all countries and sectors will not be well-suited to market mechanisms. The

World Bank's new Partnership on Market Readiness will likely go a long way to helping identify where markets can and should be deployed.

In our view, the Parties will need to generate more than one new market-based mechanism in order to be able to cover many of the types of NAMAs elaborated by the Parties to date, at the scale necessary. For this reason, this submission focuses on elaborating two different mechanisms— a NAMAs crediting mechanism which covers three different types of activities, and Credit Conversion Mechanism. IETA believes that these two mechanisms would complement the existing Clean Development Mechanism (CDM). There are likely other good candidates as well, and we look forward to commenting on the proposals put forward by Parties and other observer organizations.

The final two sections of the document are not intended to be the focus of this submission but do help to put the call for new market-based mechanisms in perspective. They go further to acknowledge the need for the development and/or identification of new ***funding sources*** and ***finance structures*** that provide the *incentive* and the *means*, respectively, to undertake reduction activities within the context of new market-based mechanisms. IETA believes that in the future it is likely that sources of funding for emission reductions will not be limited to funding generated as a result of developed country emissions caps. Indeed, many options have already been well elaborated in the recent report by the UNFCCC Secretary General's High-Level Advisory Group on Climate Change Financing (AGF).

## Principles

While IETA believes that multiple new market-based mechanisms are needed to meet the challenge of accommodating the ambitious NAMAs of developing countries post-2012, we also believe that a few clear principles should guide the Parties' efforts to develop them all.

**Be built upon robust emissions data systems.** Robust, and continuously improving institutional infrastructure for the monitoring and reporting of emissions data is necessary to facilitate the implementation of increasingly advanced emission reduction policies and activities. In order to provide the international community, including market participants, confidence in the data provided through these systems, they should aim to follow common international standards. The development of domestic infrastructure and international standards will be a gradual process that occurs over several years, but it should begin immediately.

Whilst the project-by-project[1] design utilized by the CDM remains effective and desirable in some sectors and countries— especially those with low institutional infrastructure— the consequences of limiting crediting to individual projects in well developed sectors and advanced developing countries are becoming

[1] The CDM was able to get the carbon market up-and-running in developing countries because it required little host country infrastructure to operate; all the work was done at the project site by the project developers, the DOEs, the UNFCCC Secretariat and the EB. The host country was only required to establish a DNA and issue a Letter of Approval. But now the CDM is experiencing the limitations of a piece-meal approach. Project-by-project approvals tend to be slow and cumbersome, which hobbles the CDM in delivering reductions at the large scale required.

apparent[2]. Rather than reducing the opportunities for technology transfer and finance, improvements in domestic infrastructure will in fact attract greater levels of finance and technology by enabling host countries to move beyond the limited project-by-project approach of the CDM to a broader approach that incorporates a wider varity of activities and policies at a broader level of aggregation.

**Ensure strong environmental integrity.** The rationale behind the use of any market-based mechanism is to deliver reductions of greenhouse gas emissions at least cost. It is therefore imperative that any new market-based mechanism is structured in such a way as to preserve and guarantee environmental integrity, ensuring that emissions reductions are be real, additional, and measurable; do not have adverse environmental impacts; and assist sustainable development, as defined by the host country.

The CDM addresses the criteria of real, measurable and additional through a two-stage additionalty test, establishing the baseline and then providing that the baseline is not business-as-usual. Such a method was deemed appropriate because CDM projects are considered independently and in host country situations with limited emissions data available. More advanced mechanisms will, however, operate within an increasingly well-developed data infrastructure and, as a result, can demonstrate environmental integrity and additionality at more aggregate levels and using more standardized approaches.[3]

**Be designed to attract private sector finance at scale, rapidly.** The need to attract significantly scaled-up levels of private financial flows to climate change mitigation activities is well understood, yet regularly over-looked. The AGF, IPCC, UNFCCC, IEA, and Stern and Garnaut Reports have all emphasized the significant funding gap between public pledges and investment needs. If the Parties intend to mobilize greater amounts of private sector financing into climate mitigation, they should consider engaging with the private sector when designing new market-based mechanisms. Moreover, they should clearly elaborate the private sector's role in the mechanisms from the initial design phase onward. This should include clear opportunities for public-private partnerships that take into strong consideration the need to minimize political, regulatory and financial risk for private investors.[4]

**Be adaptable to accommodate diverse countries and sectors.** A commitment to adaptability and accommodation is essential if the Parties are to direct increased financial flows to the ambitious NAMAs put forward under the UNFCCC to date. This ambition will require a willingness among the Parties to think far beyond the mold of existing offset systems and fully embrace benchmarking, statistical models, surveys, and other forms of standardization and simplification. It will require expanding beyond the definition of additionality as we know it under the CDM and recognizing that there are other ways of ensuring environmental integrity, as previously noted.

More specifically, there should be opportunities to build-in host country contribution as one step on the way to moving to a new, more-advanced mechanism. This will avoid arbitrarily shutting the door entirely

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[2] For example: the complications of interaction with advancing domestic policies (Chinese wind power and other projects); challenges to scaling up (difficulties faced by Programmatic CDM); and international competitiveness issues.

[3] See, for example, the explanation of Benchmark and Aggregate Crediting Mechanisms within the proposal for a NAMAs crediting mechanism in the next section.

[4] One feature of the CDM has been particularly successful in this respect. It has provided for a stable system of issuance through the CDM EB with delivery of credits into a non-host registry account. In addition, the CDM's prompt start provisions recognized early and pioneering projects, which in turn helped to kick-start the process of learning by doing – and to attract investors. These features should be considered in the design of new mechanisms.

on a country's participation in any given mechanism. Flexible eligibility criteria should also be considered. Eligibility should be based on sectors, not countries, as the level of advancement of different sectors in a given country may vary greatly.[5]

**Focus on scale and standardization**. One of the most significant limitations of the CDM is the way that CDM methodologies are built around very specific technologies, at one or multiple sites. The only way that we can accommodate the types of activities and policies being put forward as NAMAs today is to take the emissions accounting to a more aggregate and standardized level, as previously mentioned.

As the international community moves to develop robust sub-national and national-level emissions inventories and reporting practices, there will no longer be the need to limit methodologies to those that prove additionality for each specific technology and monitor the emission reductions caused by that specific technology. Instead, emission reduction activity should increasingly focus on multiple technological interventions, with additionality assessed on a more aggregate and standardized basis.[6]

## New Market-Based Mechanism Proposals

IETA proposes the two following market-based mechanisms for the generation of internationally fungible carbon credits. The word "offset" is very deliberately omitted here, as IETA believes that these mechanisms could generate certified credits in a capped or un-capped environment. IETA believes that these two mechanisms would complement the existing Clean Development Mechanism (CDM).

### NAMAs Crediting Mechanism

#### Basic Description

IETA recommends the establishment of a new crediting mechanism for crediting NAMAs that govern a large-scale activity or set of activities within one of the following three categories:

4. **Benchmark Crediting:** Generates emission reduction credits at the project-level based on benchmarks defined as a target level of performance of a given activity, expressed in tons of $CO_2e$ per unit output, and based on the current performance of a clearly defined population.
5. **Policy Crediting:** Generates emission reduction credits at the national or regional level based on highly standardized, country-specific methodologies that calculate conservative crediting amounts for the implementation of common policy structures (such as, feed-in tariffs) and that incentivize the widespread diffusion of clean energy and other low-emission technologies.
6. **Aggregate Crediting**: Generates emission reduction credits at a pre-defined sectoral or sub-sectoral level by establishing an aggregate baseline based partly on historic performance.

#### Rationale

The NAMAs proposed by developing countries take a wide variety of forms. Examples of NAMAs include, for example:

[5] For example, a country may have a compact and highly advanced cement sector, an inefficient, dispersed and disorganized chemicals sector and a totally unregulated domestic electricity sector. In other words, one sector may be perfectly suited to move beyond a project-based crediting system and others may not.

[6] Again, see for example, the explanation of Benchmark and Aggregate Crediting Mechanisms within the proposal for a NAMAs crediting mechanism in the next section.

- *Research and Development Activities:* such as, on renewable energy or carbon capture and sequestration
- *Implementation of Discrete Policies and Regulations*: such as, the introduction of feed-in tariffs, waste and recycling regulations, and minimum efficiency performance standards;
- *Implementation of Wide-Ranging Policies and Regulations:* such as, the implementation of a sectoral crediting program
- *Discrete Projects and Programs*: such as those registered under the CDM, though the NAMAs conception would have a wider scope.

Within the UNFCCC, discussion has focused on where the funding for NAMAs will come from. This has led to a discussion of the following three types of NAMAs:

- *Unilateral NAMAs,* which a country will self-fund;
- *Conditional NAMAs,* which will be implemented with developed country assistance, in the form of financing, technology transfer and/or capacity building; and
- *Carbon Market NAMAs,* which are eligible for support in the form of crediting for emission reductions achieved.

IETA believes that the appropriate type of each NAMA proposed should be largely determined by the following criteria:

- host country ability to carry out the activity unilaterally, in terms of governance and implementation capacity, finance availability, and technology availability;
- host country willingness to bear the financial burden of the activity, taking into consideration other co-benefits, compatibility with development objectives, and the country's per capita and absolute greenhouse gas emissions (i.e. contribution to and responsibility for climate change);
- host country interest in participating in the international carbon market; and
- ability to quantify and verify, at reasonable cost, the resulting emission reductions with a level of certainty deemed acceptable by the Parties.

It is with this in mind that IETA proposes this new NAMAs crediting mechanism, which focuses on:

(1) improved emissions data management requirements and
(2) standardizing and aggregating the quantification of emission reductions.

Under such a system, it would be in the best interest of developing countries to improve their data systems and move to crediting at greater scale, because it would allow them to gain access to ever-greater amounts of financing (see next section for more on finance options). For example, the CDM attracts finance for, e.g, one renewable energy installation or one technological intervention in a facility. In contrast, a Benchmark Crediting should be designed to attract finance for several different installations and multiple energy saving technological or managerial interventions in those facilities. Further, Aggregate Crediting or Policy Crediting should be designed to attract finance to the whole sector or sub-sector.

The transition from one type of crediting to the next can only take place with the growth and development of infrastructure. Indicators of industries which have sufficient infrastructure would include those with an accurate database of facilities and their historic emissions; a permitting system; good quality monitoring and reporting of emissions; ability to effectively regulate the industry. If these are lacking, then the CDM may be more suitable, but over time, CDM projects and international donors should help the industry develop this infrastructure.

### Technical Concerns

Compared to CDM, these activities require a much higher level of emissions monitoring and reporting infrastructure and greater host country participation. For example, a host country would need to define

the covered sectors or activities, determine baselines and benchmarks, promote equal treatment of participants, possibly re-distribute some of the revenues to account for early action/competitiveness issues, etc. The design issues related to policy crediting and aggregate crediting will be many, especially in relation to the integration and incentivization of private sector actors. Early involvement of the private sector will help meet these challenges, however.

## Credit Conversion Mechanism

### Basic Description

IETA recommends the establishment of a new mechanism to convert environmental commodity credits of diverse denominations into internationally fungible credits. This mechanism will convert units of a different denomination (MWh, e.g.) into metric tonnes and thereby certify them for international transfer. Certified emission reduction credits could be issued for countries that develop new domestic environmental commodity trading systems or increase the ambition of their already-existent systems.

### Rationale

As already mentioned, diverse political, regulatory and legal structures across the world ensure that Parties will have different preferences with respect to how they incentivize domestic emission reductions through environmental markets. They may choose to utilize domestic CO2e emission trading systems, or another environmental commodity trading system, such as energy efficiency trading or renewable energy credit (REC) trading. The Credit Conversion Mechanism would provide a means to harmonize these various forms of crediting into a single international currency. This would promote better access to international climate finance for developing countries without being overly prescriptive in how they organize their emission reduction efforts. A Credit Conversion Mechanism would allow Parties, on an entirely voluntary basis, to link up with international emissions trading even though their respective environmental products are of different denominations. This mechanism would enable the certifying body to apply a conversion that translates domestic units into fully fungible international units.

### Technicalities

Further developing this mechanism would require significant further work. Conversions would likely need to be standardized based on, among other things, country and/or region-specific grid emissions factors. Concerns about double-counting would have to be taken very seriously. Significant exploration would need to be undertaken regarding how to differentiate and convert among MRV standards, if an international standard could not be agreed.

**Example:** India's Perform, Achieve and Trade (PAT) mechanism to enhance energy efficiency is based on energy intensity rather than an absolute measure of energy usage. It allows absolute energy usage growth while rewarding improved energy efficiency and will translate energy intensity performance into actual energy savings to enable the trading of a unit of energy saved: metric tonnes of oil equivalent (MTOE). If international emission reduction credit buyers want to purchase reductions made in India as a result of the PAT

## Finance and Funding Options

As explained in the introduction, the development of new, scaled-up market-based mechanisms must be accompanied by the development and/or identification of methods to develop ***funding sources*** and ***finance structures*** that provide the *incentive* and the *means*, respectively, to undertake reduction activities in the context of that new market-based mechanism.

It is important to reiterate the distinction between *funding* and *finance explained in the introduction*. *Funding* refers to the generation of money—or, more precisely, the generation of the incentive to expend money— for a particular activity. In the context of emissions trading, the amount of *funding* available is akin to the *demand* for carbon credits, which is directly related to the stringency of emissions caps. *Finance*, on the other hand, refers to the structures available to put that funding to use and to leverage it into more funding, where necessary, in the sense of creating borrowing structures and/or blending different funding streams together.

The following two sections elaborate more upon the need for and viability of additional finance tools and funding options to help facilitate emission reduction activities in developing countries. **To be clear, these are not proposals for additional market-based mechanisms, like the two in the previous section.**

### Finance

Given the difficulties faced by many project developers in acquiring finance for CDM projects with even relatively small investments, IETA believes that the identification of financing options is just as critical as the development of market-based mechanisms to certify emission reductions.

Low-carbon investment is simply difficult to incentivize in many developing countries, especially when large amounts of investment are needed. It is clear that traditional project finance will not be sufficient to meet the needs of mechanisms designed to facilitate the wide range of emission reduction activities outlined in countries' NAMAs pledges. Ensuring sufficient private financing in many cases will require bringing down the investment risk, and IETA believes strongly that additional finance tools will need to be created that enable the necessary risk-sharing between the public and private sectors.

In the post-2012 world, the financial tools needed for mitigation activities will likely vary drastically and could take a number of forms depending on the type of NAMA and the economic and political conditions of the country. IETA believes that what is likely is a mix-and-match, similar to what is depicted in the table below. A selection from table A could be combined with a selection from table B to create a functional emission reduction package. Not every finance tool will be a good match for every emission reduction tool, and countries and sectors ability to access these tools will depend on economic conditions and the emissions monitoring infrastructure in place.

| A. Financial Tools |
|---|
| Traditional Project Finance |
| Traditional Bond |
| Green NAMA Bond* |
| Fund |
| Special Purpose Vehicle |
| Other |

| B. Market-Based Mechanism |
|---|
| CDM |
| NAMAs Mechanism: Policy Crediting |
| NAMAs Mechanism: Benchmark Crediting |
| NAMAs Mechanims: Aggregate Crediting |
| REC Trading Mechanism (credits converted through Credit Conversion Mechanism) |
| REDD Mechanism |

## Green NAMAs Bonds

### Rationale

In an effort to contribute to the work to improve access to finance for NAMAs, IETA puts forward a proposal for a financial instrument aimed at getting the bond market interested in low-carbon investment.

The case for finding a means of making low-carbon attractive to mainstream private sector investors is well-known. IEA modeling indicates that more than $1tr a year of additional, non-economic investment in the energy sector alone is needed to achieve greenhouse gas reduction targets. A very large proportion of this is in the developing world.

China and some other developing countries are focusing on the development of low-carbon technologies, hoping to sell to the developed world and prepared to create a home market as a platform. This is creating the impression that low carbon technology will be economic across the world, driven by feed-in tariffs and regulation. Low-carbon investment funds and Green bonds are being created on this basis. Yet most developing countries will not accept that they should pay the cost of these support instruments, without which the investments are mostly unviable. There is a potential investment gap of hundreds of billions of dollars a year. There is no realistic prospect of direct aid from developed countries increasing to fill this gap.

Very substantial new private sector investment, coming from investors who have low appetite for risk and need large-scale opportunities, needs to be leveraged by the support that the developed countries can afford. This support needs to be stretched to the maximum. The scale and useability of the leverage instruments needs to be far, far greater than has been achieved by the CDM, for all its success as a pioneer in global carbon pricing. No coherent plan is on the table for achieving this leverage; there are only vague references to scaling up the carbon market.

As explained previously, the expectation is that developed countries will support many of the NAMAs put forward under the UNFCCC by developing countries, through the carbon market, through direct public grants, or through a combination of both.

### GNB Explained

Some NAMAs could be capable of being structured as large-scale calls for private sector investment and registered under the NAMAs crediting mechanism proposed in this submission, which would enable them to be credited through a new market-based crediting mechanism.

With this in mind, Green NAMA bonds are a vehicle combining:

- conventional returns from sovereign or quasi-sovereign borrowers,
- the benefit of conditional and limited guarantees from international financial institutions (IFIs) that make developing country borrowers less risky and more acceptable to conventional investors
- underlying project returns expressed in conventional financial terms, and
- returns in the form of carbon units that can be used for compliance by companies or Governments with obligations under carbon trading systems (UN-linked or national) or can fulfill voluntary emissions reduction commitments.

**Example:**

- A developing country Government asks an IFI for a loan for an economic proposition, e.g. to modernize a part of the country's electricity supply industry
- The governing body of the NAMAs Crediting Mechanism works with the host country to estimate the emissions reduction impact
- The governing body of the GNB works with the host country to elaborate the conventional economics of the proposition
- If satisfactory, the IFI authorizes the proposition to be constituted as a bond issued by the Government at a low coupon reflecting the degree of IFI support (which makes it more attractive to the bond market).
- The return to bond holders includes a share in the underlying returns from domestic electricity sales and some or all of the carbon return, meaning the emissions reduction units or proceeds from the sale of those units.

A very simple example of how a GNB could work is laid out in the box to the left.[7]

### Further Elaboration

Early real-world experiments could be possible making use of some or all of the features outlined in the box. The package could also be enhanced by export credit support arranged between the borrower and developed country equipment suppliers, for proposals involving major capital investment.

While the concept is unfamiliar, tricky balances would need to be struck to deal with existing policy or risk parameters of a host country, an IFI or investors, or elements might need to be left out. But this is the case with the birth of any new class of financial instrument.

To begin with, it can be expected that institutional investors would be cautious about the proportion of their return they would accept in carbon reduction units: these are still unfamiliar, and there is political risk involved. The carbon element could be an additional benefit, a "kicker" diversifying the risk and return profile in an interesting way. As familiarity grows and emissions reduction ambition by countries across the world increases, the appetite for a greater share of the return in the form of carbon will increase as well.

## Funding Options

As previously discussed, financing is only a means of structuring the spending side of an economic proposition. A very substantial part of the climate change problem is that there is no conventional economic proposition. Without a price for the externality of emissions reductions, they have no economic value, and normal economic actors in the economy – companies and businesses – will have no direct reason to spend money in trying to achieve them. Regulation requiring companies and businesses to make reductions provides the basis for a price and for valuing these emissions. The great achievement of the

[7] An alternative could be to create an implementation agent as an SPV, receiving the bond proceeds from the Government, managed by Board members including the IFI and perhaps private sector representatives, and distributing the bond funding to the entities involved in the programme to use as part or all of their funding for the specific investments necessary to achieve the NAMA.

architects of the Kyoto Protocol was to find means by which this value could be placed on emissions reductions, wherever they occurred in the world. The essence of the KP mechanisms is that they are mechanisms for transferring an economic incentive to where it can be responded to most efficiently, and where for political reasons there is no comparable incentive in place. The transfers could in principle be achieved by a series of bilateral agreements and deals, but a market acts as the most efficient broker for this activity.

So looking for a new market-based mechanism, following the pioneering work of the KP, can also mean looking for other ways to create an economic incentive and using the market to distribute it.

The incentive behind the KP is essentially a negative one: the compliance value of the KP targets, distributed to countries and companies so as to create the possibility of a loss in the case of non-compliance. In this system, the funding on which financing mechanisms can be based is the money equivalent of the stream of reductions that satisfy compliance goals somewhere.

### Other Forms of Incentive

A different form of market-mediated incentive is the voluntary emissions reduction market. Some companies see a reputational rather than a compliance need to demonstrate emissions reductions, typically to compensate for emissions or footprints they cannot reduce through their own operations. The value will be highly variable between companies, but there is enough demand from this source to create a healthy, though still small, voluntary section of the carbon reduction project market.

In principle this form of demand could be regulated into a compliance demand too. Rather than being valued as a means of offsetting companies' own emissions so as to help bring them down to a regulatory cap, emissions reductions could be required as a means of reducing overall carbon footprints where a company is required to take responsibility for the footprint of the whole supply chain rather than only the emissions that occur in their production facilities. This is one response to the concerns that developed country emissions are being exported to the developing world along with parts of the supply chain. It is also a response to the linked point that after some years the developed world will run out of all but the most expensive emissions reduction options, so there will be nothing left to offset, but global emissions will still be rising. The existing emissions reduction project market, or the forthcoming NAMA reductions market, could supply this need. However the politics of introducing these new types of developed country obligation at the national level, let alone having the system run and obligations imposed by UN bodies, mean that this is not a practical option at this stage.

### Using the Market to Distribute Public Funds

The emissions cap compliance incentive, and other forms of compliance incentive, are Government impositions on companies, and through them their shareholders and customers. If Governments prefer to make impositions on taxpayers, the incentive can be presented as a positive rather than a negative one – but the end result is still that a certain amount of money is made available to fund emissions reductions. IETA's view has always been that collecting a sum of money to pay for emissions reductions is less efficient than identifying a level of desired emissions reductions and distributing the reductions directly around a market, but this can be set aside for now. Also, it is not the purpose of this submission to compare means for collecting these funds or identifying the taxpayers concerned: the report of the UN Secretary-General's Advisory Group on Financing, published before Cancun contains many ideas here, such as a levy on the global aviation and maritime industries and a "Tobin tax" on financial transactions, on which IETA is not expressing a view. Nor is IETA expressing a view here on exactly who would be the repository and main distributor of the funds, though the new Green Fund and the World Bank or other implementing agencies are obvious candidates, and market principles would suggest that a number of institutions should be acting to some degree in competition rather than there being a monopoly supplier of funds.

The mechanism needed is a market-based distribution of the available funds, however they are collected. This must mean buyers and sellers brought together in some combination of auction, tender and marketplace. The funds can be auctioned, probably in tranches, to bidders who could be combinations of public and private bodies, with the auction decided on the basis of the largest promise of reliable emissions reductions for the smallest amount of funding. Or tenders could be requested, with specific outcomes more complex than a simple reductions: money ratio, and perhaps on the basis of the involvement of the implementing agency as a partner in the reductions proposal. Or specific projects and proposals, with estimates of their emissions reduction potential, could be posted to a global marketplace – which is essentially what happens with current CDM and voluntary market projects and the direction in which ideas for developing the concept of supported NAMAs is heading – in which one or more funding institutions would search for the best value.

Obviously there is no role here for the private sector as ultimate purchasers, though it is possible to imagine emissions reductions coming from these processes being expressed in a form that could be fungible with units from the conventional offset market. There is, however, a role for the private sector as project originators and assemblers, as well as with the identification and measuring of the emissions reductions, and as the managers and providers of services to the markets or auctions.

To increase efficiency, some degree of market discipline should be applied to the choices made by the holders of the funds or the implementing agencies (or their contracted specialists). Performance indicators expressed in terms of ratios of emissions reductions per dollar, and competition for the best propositions, seem desirable. It is important, to achieve the global reach looked for by the architects of the KP mechanisms, that the funds should operate on a global basis. Different institutions, both international and national, could participate on the buy side of a single marketplace, or a series of auctions or tenders, with efficiency added by the international standardization of offers and requirements, including the standardization of the reductions achieved or promised. These are key ways in which what is suggested here differs from the existing activities of some parts of the IFIs, though there is a number of partial precedents in operation.

So a new market-based mechanism— like the two proposed by IETA in this submission— can be constructed on the back of a different stream of economic value to the compliance-offset value that has driven the KP mechanisms. Many of the features of the existing emissions reduction market, or emerging developments in the direction of NAMAs reductions, could be replicated. Or a more tailor-made set of requirements for emissions reduction packages at scale could be created, reflecting the smaller number (though preferably not a monopoly) and greater purchasing power of the Government or UN-appointed buy-side.