COMMENTS ON THE DEVELOPMENT OF NEW MARKET MECHANISMS PURSUANT TO CANCUN AGREEMENTS

On behalf of: Natural Resources Defense Council, Environmental Defense Fund, and Union of Concerned Scientists

The Cancun Agreements[1] decided to "consider the establishment, at its seventeenth session, of one or more market-based mechanisms to enhance the cost-effectiveness of, and to promote, mitigation actions…" These comments are in response to the request for views from Parties and accredited observer organizations.[2]

WHY WE NEED WELL-DESIGNED MARKET MECHANISMS

The developing world is projected to invest roughly $11 trillion in energy over the coming 25 years.[3] Without strategic, comprehensive, long-term policy support these investments will lead towards an energy infrastructure which will lock in significant carbon emissions, the primary driver for climate change. In addition, reducing emissions from deforestation and forest degradation (REDD) by half requires investments of about $25 billion per year over the next decade.[4] Appropriate, well-designed market mechanisms can help reduce emissions cost-effectively and quickly, thus playing an important role in helping to ensure that these investments move the world towards a path that reduces the impacts of climate change. Taking advantage of these mechanisms will be hugely beneficial in raising the scale of funding needed to cope with climate change, especially give the urgency of the problem we face.

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[1] Outcome of the work of the Ad Hoc Working Group on long-term Cooperative Action under the Convention, available at: http://unfccc.int/files/meetings/cop_16/application/pdf/cop16_lca.pdf

[2] See para 82.

[3] World Bank. http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21513875~menuPK:34480~pagePK:64257043~piPK:437376~theSitePK:4607,00.html

[4] See for example, Boucher, D.H. 2008 Out of the Woods: A realistic role for tropical forests in addressing global warming. Union of Concerned Scientists, Cambridge, MA, USA. Available online at: www.ucsusa.org/REDD; Eliasch, J. 2008. Climate change: Financing global forests (the Eliasch Review). London: Office of Climate Change, Government of the United Kingdom; Meridian Institute (Zarin, D., A. Angelsen, S. Brown, C. Loisel, L. Peskett, and C. Streck). 2009, Reducing Emissions from Deforestation and Forest Degradation (REDD): an options assessment report. Meridian Institute and Government of Norway, Washington, DC, USA. Available online at: www.REDD-OAR.org

Ill-designed market mechanisms, on the other hand, can lead to the waste of scarce climate funding resources and a loss of public trust in such mechanisms. Such a scenario would set back efforts to mobilize the needed resources as the public and governments would find it difficult to argue for the use of carbon market mechanisms in the implementation of their domestic emissions mitigation policies.

While there are legitimate concerns related to existing market mechanisms such as the CDM, these should not be used as a rationale for doing away with market mechanisms all together. Rather, examples like this highlight the importance of good design and strong monitoring and oversight provisions. The hope is that any future market mechanisms will incorporate strong provisions to address the principles below. Of course, other non-market mechanisms to raise funds for mitigation and adaptation (public and private funding sources) are also critical and can play a complementary role.

DIFFERENT MEANS BY WHICH MARKET MECHANISMS CAN CONTRIBUTE TO CLIMATE FINANCING

A diverse set of funding sources, including both market and non-market mechanisms, will be required to deliver financing to realize the full mitigation and sustainable development actions necessary to combat climate change. Market mechanisms can contribute to climate financing in several different ways. First, when nations or entities reduce emissions below a baseline emissions level, and then, through a market mechanism, sell the resulting emissions credits to entities or nations which have adopted absolute emission limitation and reduction objectives, the revenue from those sales can be directed to help finance more emission reductions. Second, when nations or entities participating in absolute emission limitation and reduction programs establish emissions allowance trading programs to help them meet the objectives of these programs, the programs encourage investment in innovative low-carbon technologies and processes. That is because every emission reduction investment has the potential to generate an economic return if it reduces emissions below allowable levels and thereby renders surplus some of the scarce, valuable commodity – emissions allowances, which can then be saved for future sale or use. Third, when nations participate in emissions trading programs, they can set aside a portion of their emissions allowances and direct, toward climate finance, revenues generated from the sale of these set-aside allowances.

OPERATIONAL PRINCIPLES FOR ANY NEW MARKET-BASED MECHANISM[5]

The decision under the Ad Hoc Working Group on long-tem Cooperative Action Under the Convention (LCA) as a part of the Cancun agreement sets out some guiding principles for development of new mechanisms:[6]

[5] The use of set asides would likely require a different set of principles to guide how those resources are utilized.
[6] See para 80.

"(a) Ensuring voluntary participation of Parties, supported by the promotion of fair and equitable access for all Parties;
(b) Complementing other means of support for nationally appropriate mitigation actions by developing country Parties;
(c) Stimulating mitigation across broad segments of the economy;
(d) Safeguarding environmental integrity;
(e) Ensuring a net decrease and/or avoidance of global greenhouse gas emissions;
(f) Assisting developed country Parties to meet part of their mitigation targets, while ensuring that the use of such mechanism or mechanisms is supplemental to domestic mitigation efforts;
(g) Ensuring good governance and robust market functioning and regulation;"

These guiding principles provide the framework for ensuring that new mechanisms further efforts to address climate change. To take them forward to the implementation stage, operational guidelines are also necessary. In developing any new mechanism we urge that the following operational guidelines are taken into account.

1. Establish strong requirements of environmental integrity

To ensure environmental integrity (as specified in para 80(d) of the LCA Decision in Cancun), any new mechanism, at a minimum, would need:

(a) Transparency. Strong standards will need to be implemented to ensure that actual emissions can be compared readily with reported emissions, reported NAMAs, and reported reductions; and to ensure that all transactions are serialized and tracked so as to avoid double-counting and double-selling. Meeting these requirements will entail strong standards for monitoring, reporting, and verification (MRV), and may include third-party certification.

(b) Ensuring a net decrease and/or avoidance of global greenhouse gas emissions. Any new crediting mechanism that is developed should ensure that credits are only given to the extent that new and real emissions reductions are achieved (i.e., that level of emissions cut is below what would have been achieved without the incentive of the mechanism); however, since "offsetting" alone is not sufficient to ensure a net decrease and/or avoidance of global emissions, we suggest further principles aimed at meeting the goal of ensuring a net decrease and/or avoidance of global emissions that achieves Article 2 of the Convention (see principles (2) and (3) below).

(c) Permanence/durability. Two policy components are crucial for providing incentives for market actors (countries, companies, and possibly also communities) to seek the most permanent/durable reductions. One is to for policy-makers to adopt successive multi-year emissions limitation periods, lasting in total for several decades, in order to send a signal to market actors that they should be making durable investments. There should be provisions for making surplus tradable units "savable" or "bankable" from

one emissions limitation period to the successive ones, so that emitters have incentives to reduce even further during one period in order to be able to save the units for use or sale during successive periods. In addition, the action should be lasting so that the emissions reduction isn't "reversed" in the future (e.g., ensuring protections against reversibility in forestry activities).

(d) *Provisions for review/updating.* Built-in to the system should be provisions to review/update the mechanisms to take account of the best available science. Governments should be careful to not arbitrarily change the system and should make any rule changes in accordance with previously announced rules for review/updates.

2. ***Market mechanisms for generating emissions reduction credits (i.e., credits for activities that reduce emissions below what would have otherwise occurred) should quickly transition to sector-wide limitations based on actual recent emissions data for most sectors. Least developed countries would not be required to make this transition but at their request should be given extra assistance in making this transition.[7] In addition, sector-wide baselines should be updated periodically.***

As initially implemented, two of the current international market mechanisms for generating emissions reduction credits (i.e., the Clean Development Mechanism and Joint Implementation) focus on project-by-project crediting of reductions below what would have otherwise occurred. More recently, the CDM has begun to open up the possibility of "programmatic" approaches. The development of new mechanisms should likewise transition away from project-by-project and programmatic approaches to encourage carbon market participation at a sector-wide level via baselines calculated on the basis of actual recent emissions data.

By shifting market-based mechanisms to a sectoral basis, new mechanisms could overcome the high transaction costs that have hobbled the project-based mechanisms. By shifting from what-would-have-otherwise-occurred baselines to baselines calculated on the basis of actual recent emissions, such new mechanisms could promote environmental integrity and ensure net global reductions. Together, the sectoral and baseline shifts would encourage the development of robust policy and institutional frameworks to foster systematic approaches to address mitigation.

The transition to sector-wide mechanisms should begin quickly. For credit based systems, there should be an established maximum date by which marketable emissions credits would only be recognized on the sectoral or national baseline approaches (with the two exceptions noted below).

This sector-wide principle would apply with two important exceptions:

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[7] LDCs could choose to utilize a sector-wide mechanism from the outset and would be given support in making this transition.

(a) *Select sectors.* Due to their heterogeneity, project-by-project crediting of reductions-below-what-would-have-otherwise-occurred could still be recognized for a limited set of activities, possibly including afforestation/reforestation and waste management.

(b) Least Developed Countries (LDC). We suggest that Least Developed countries would be excluded from the requirement to transition to sector-wide reductions, but could obtain special support for doing so if they wished to make the transition. This means that all sectors in LDCs could still be eligible to generate credits on a project-by-project basis. This will not have a material effect on the scale of emissions (because their emissions are relatively negligible) and could nevertheless have important beneficial effects in enabling a transition to clean technologies.

Such an approach is consistent with para 80 (c) and (e) of the LCA Decision in Cancun.

3. A Party's eligibility for market mechanisms should depend on whether allowing tradability of its unilateral emissions reduction commitment, i.e., the nationally appropriate mitigation action it has inscribed as noted in paragraph 49 of the Cancun Decisions, meets the goal of ensuring a net decrease and/or avoidance of global greenhouse gas emissions in a timeframe consistent with meeting the objective of the Convention[8]

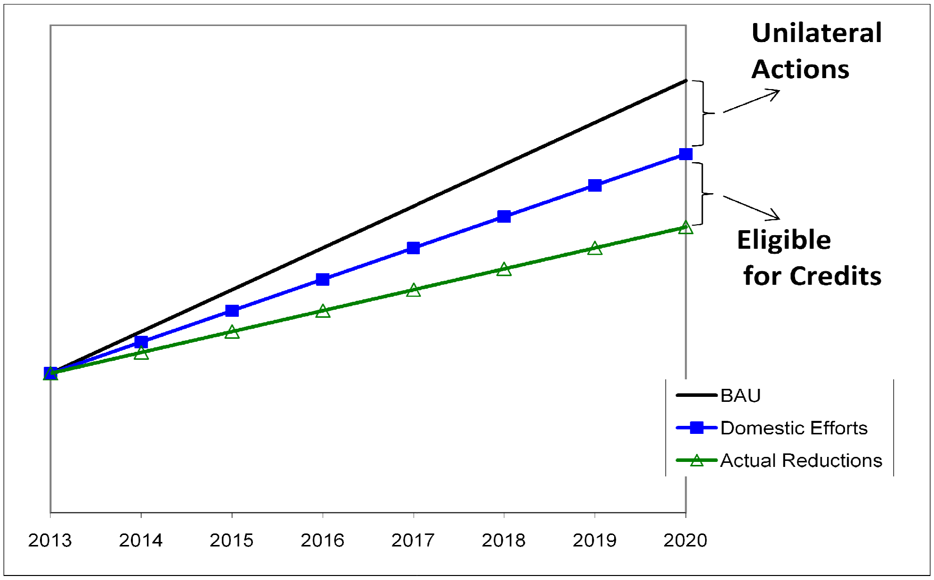
Countries accounting for over 80% of the world's greenhouse gas emissions have made commitments to reduce their emissions, pursuant to the Cancun Agreements. Most of these commitments outline the level of action that the Party will undertake on its own—its "unilateral" action.[9] In the case of a developing country Party whose nationally appropriate mitigation action is noted in paragraph 49 of the Cancun Decisions, credits below that baseline can only be generated if the baseline is stringent enough to be consistent with the goal of ensuring a net decrease and/or avoidance of global greenhouse gas emissions. In the illustration below, allowing tradability of the increment of reductions between the black and blue lines would not help achieve the goal of ensuring global net reductions, since the result of the transfer would be a continuation of increasing net emissions. However, allowing tradability of the increment of reductions between the blue line and green lines could result in a net reduction in global emissions. Crucial to this determination is the ambition of the blue line. Defining that level of ambition is a field that needs considerably more work.

In terms of financing, a Party might choose to finance its unilateral actions (those between the black and blue line) through its own resources, by means of external financing, by financing from the set-aside and auctioning of allowances in its domestic emissions trading programs, by applying a "discount" to traded units (these latter two serving as a "rent" from trading), or by a

[8] See UNFCCC Article 2 ("The ultimate objective of this Convention and any related legal instruments that the Conference of the Parties may adopt…"

[9] For countries which haven't spelled out their "unilateral action" it will be important to do so.

range of other means. What is important is not the source of the financing, but the level of reductions.



Over time, the crediting baseline should decline so that the system transitions away from "offsets" to contributions from all countries towards global emissions reductions.

Such an approach is consistent with para 80 (e) of the LCA Decision in Cancun.

4. *Market mechanisms should include mechanisms for reducing deforestation emissions with strong environmental principles and environmental/social safeguards*

There has been extensive discussion on mechanisms to support efforts to reduce deforestation and forest degradation emissions. As the Parties consider these options, we suggest that countries include REDD+ as a part of the market system. In addition to the above principles (1-3) we recommend REDD+ market mechanisms are designed: to minimize and address leakage; with strong environmental and social safeguards; and to account for all significant sources of emissions from deforestation and degradation within the covered jurisdiction.

5. *No HFC credits*

The LCA decision in Cancun sets out that: "in developing and implementing the [new] mechanism or mechanisms…to maintain and build upon existing mechanisms, including those established under the Kyoto Protocol".[10] We believe that carbon credits for HFCs shouldn't be allowed in the future.[11] So any "maintaining" or "building upon" existing mechanisms should ensure that such credits aren't allowed in the future. Instead, we support efforts to control HFCs

[10] See para 83.
[11] See: Natural Resources Defense Council, *Making Climate Change and Ozone Treaties Work Together to Curb HFC-23 and Other "Super Greenhouse Gases"*, available at: http://www.nrdc.org/globalwarming/files/hfc23.pdf

under the Montreal Protocol and for developing an appropriate financing mechanism to support their phase-down under that Protocol.

The Work Ahead: Workplan on New Market Mechanisms for 2011

In order to consider a Decision on New Mechanisms at COP17, Parties will have to undergo a thorough and detailed set of discussions in the coming months to be able to prepare a draft Decision which answers a number of the critical challenges facing any new mechanism. Some issues that will have to be further detailed include:

- How to define baselines for each type of market mechanism?
- What level of rigor is required for the MRV of any new mechanism?
- For those sectors and least developed countries where "offset crediting" would continue to be available, how do you turn the concepts of "real, additional, and permanent" into operational guidelines?
- Over what time horizon based on climate science should "offset" credits be phased out for all but the least developed countries?
- What legal, policy, and institutional support is needed to help nations build capacity to participate effectively in the range of market mechanisms contemplated here? How can non-market mechanisms be helpful in building these legally, policy, and institutional capacities?

Addressing these issues will likely require both workshops and detailed negotiations to ensure that a decision on any new mechanisms establish the right frameworks.

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