



Joint OECD/IEA submission to UNFCCC, March 2012: Views on a "Framework for various approaches to enhance cost-effectiveness of, and to promote, mitigation actions" and "Modalities and procedures for a new market-based mechanism"

Draft decision -/CP.17 on the outcome of the work of the Ad Hoc Working Group on Long-term Cooperative Action (AWG-LCA) invites admitted observer organizations to make submissions to the UNFCCC secretariat, by 5 March 2012, on their views on:

i) a framework for various approaches, including opportunities for using markets, to enhance the cost-effectiveness of, and to promote, mitigation actions (paragraphs 79 and 80); and

ii) modalities and procedures for a new market-based mechanism, operating under the authority and guidance of the COP, to enhance the cost-effectiveness of, and to promote, mitigation actions (paragraphs 83 and 84).

The Organisation for Economic Co-operation and Development (OECD) and the International Energy Agency (IEA) jointly welcome the opportunity to submit views on these important issues. The submission covers both topics in two separate sections.¹

Part 1: Framework for various approaches, including opportunities for using markets, to enhance the cost-effectiveness of, and to promote, mitigation actions (paragraphs 79 and 80)

A "Framework for various approaches" (hereafter referred to as "the Framework") could provide structure or guidance to both market and non-market mitigation activities implemented by Parties under the UNFCCC. Part 1 of this submission focuses on a Framework for market approaches, including the trade of credits generated under the authority of Parties or groups of Parties. The new market-based mechanism defined at COP 17 is discussed separately in Part 2 of this submission.

Purpose of the Framework

If adopted, it would be important to clarify the purpose of the Framework as it relates to market approaches developed by Parties. Market mechanisms are likely to be implemented outside of the UNFCCC process in developed and developing countries, regardless of whether a UNFCCC Framework is adopted. One of the purposes of the Framework could be to promote consistency and transparency of market-based mechanisms developed under the UNFCCC, and to facilitate links between these mechanisms and others outside the UNFCCC framework. Transparency and consistency between different market mechanisms will improve unit fungibility and maintain international trust in the use of market mechanisms. Another purpose of the Framework could be to

¹ This submission has been compiled using published reports of the Climate Change Experts Group (CCXG), formerly known as the Annex I Experts Group (AIXG), for which OECD and IEA provide a joint Secretariat. These papers are available for download at <u>www.oecd.org/env/cc/ccxg</u>.





allow recognition under the UNFCCC of units generated from country-led market mechanisms. In other words, the Framework could provide a means for countries to use units from non-UNFCCC market mechanisms to meet part of their mitigation targets or goals under the UNFCCC. The Framework could also inform potential use of market mechanisms as part of a post-2020 agreement under the Durban Platform for Enhanced Action.

It would also be important to clarify the interaction between the Framework and the new marketbased mechanism defined at COP 17 to be under the guidance and authority of the COP. A marketbased mechanism is driven by a balance of supply and demand. If Parties have the option to use UNFCCC-recognised units from country-led market mechanisms to meet part of their mitigation objectives, this could in effect increase supply of UNFCCC-recognised units and therefore impact demand for GHG units from the new market-based mechanism under the UNFCCC.

In terms of governance, key decisions would need to be taken regarding what is agreed internationally and what is decided and developed outside the international process. For example, detailed rules for the CDM have been developed at the international level, whereas detailed rules for emissions trading systems have often been developed at national level. This submission assumes that the modalities and procedures for the new UNFCCC market-based mechanism will be developed in detail at the international level, albeit with some flexibility in implementation (addressed in Part 2 of this submission), whereas the Framework may be more briefly defined at the international level, allowing greater flexibility for Parties to implement their own market-based approaches.

Unit-based emissions accounting under the Framework

If a purpose of the Framework is to allow a means for diverse unit types to be recognised under the UNFCCC process as valid towards meeting Parties' mitigation targets and goals, then it will be important to ensure that any greenhouse gas (GHG) units created outside of the UNFCCC system are correctly accounted for. The issue of accounting for emissions units is intertwined with the wider issue of national accounting for emissions, including the scope and terms of emissions mitigation targets and goals, and the measurement, reporting and verification (MRV) of progress towards those goals. Countries involved in international trade of UNFCCC-recognised GHG units under the Framework would ideally agree a common basis for their targets or goals in order to avoid double counting – a basis that takes into account GHG unit flows into and out of the country, as well as changes to the domestic emissions inventory. Perhaps the simplest common basis would be if national mitigation pledges are expressed as total emissions to be emitted over a fixed timeframe, with sources and sectors clearly stated according to common terms. Without clear quantitative definitions of emissions goals and targets, adding or subtracting GHG units becomes less meaningful.

Governance of country-led crediting mechanisms under the Framework

A key purpose of the Framework could be to provide a level of international co-ordination, through the UNFCCC process, of international market mechanisms implemented by Parties. In theory this could involve units from domestic emission trading systems (ETSs) as well as offsets issued through crediting mechanisms. However, national, sub-national or regional ETSs have usually been initiated as domestic instruments whereby trades occur only within the country (or regional) boundary. In this way ETSs serve to stimulate emissions abatement within the boundary and the trading units are not





used directly as a contribution to meeting the country's international pledge. ETS units are therefore not usually relevant from an international unit accounting perspective and may not be a concern for the Framework in the short-term.² This submission focuses instead on crediting mechanisms.

Recent CCXG analysis presented two options for governance of crediting mechanisms implemented by Parties. The options explore different levels of international co-ordination of crediting mechanisms developed by countries that could apply to recognition of units under the Framework.³

A Framework based on agreed criteria for international recognition of credit units

The option with greater international co-ordination would represent a move from a project-level approval process towards one that focuses on mechanism approval under the Framework. The UNFCCC process would continue to play an important co-ordination role of country-led offset mechanisms. Parties would agree common criteria for recognising units from country-led mechanisms, such that only units issued by mechanisms conforming to the criteria would be recognised as valid units for meeting national mitigation targets or goals in the UNFCCC process. Such criteria could focus on ensuring that a mechanism has certain quality-assurance processes in place, rather than on detailed international scrutiny of specific projects or activities. This option would represent a clear departure from the CDM where the CDM Executive Board, as a body under the UNFCCC, regulates the whole process at the project or programme level.

Three broad areas are proposed where criteria for unit recognition could be applied to ensure a level of environmental quality: (i) project/activity eligibility criteria, (ii) methodology principles, and (iii) monitoring standards.

(i) Project/activity eligibility criteria would provide some assurance of environmental quality for emissions units issued from emission reduction activities whilst maintaining sufficient flexibility for countries developing bi- or pluri-lateral crediting mechanisms and remaining attractive to private sector investors. Such criteria could include:

• Implementation of an environmental quality test – a requirement on crediting mechanisms to employ a means for demonstrating the environmental integrity of units issued. Developing a common standard for environmental quality tests may be difficult and details of the test would be designed by the countries implementing each mechanism, with the proviso that the test can be shown to be sufficiently stringent to meet the UNFCCC criteria. The criteria could require that mechanisms demonstrate that emissions reductions are real and measurable; that

² If ETSs in different countries link directly, creating international pools of fungible allowance units, then the quality of such units might become a concern of the Framework. For more information see Prag, A., C. Hood, A. Aasrud and G. Briner (2011), "Tracking and Trading: Expanding on Options for International Greenhouse Gas Unit Accounting After 2012", <u>http://www.oecd.org/dataoecd/61/35/49101167.pdf</u>

³ The CCXG analysis (Prag *et al.*, 2011, as in footnote 2) also presented a third option involving centralised governance through the UNFCCC process. This option corresponds more closely to the new market-based mechanism under the UNFCCC and is discussed in Part 2 of this submission.





activities credited under a new scheme are new; and that clarity is given on overlaps between credited activities and host country regulation.⁴

- Evidence that relevant emissions-related data is of sufficient quality
- Demonstrated voluntary consent from all Parties involved in the mechanism
- Ensuring that emissions reduction projects or activities are based on clear, publicly-available methodologies or protocols

(ii) Methodology principles or guidelines: If Parties agree that the use of clear methodologies or protocols to describe activities is to be a minimum requirement for credited GHG units to be recognised under the Framework as eligible to assist countries in meeting mitigation objectives, further criteria could be developed around the structure or content of such methodologies. Agreeing guidelines in this way would contribute to comparability of mechanisms in a more fragmented carbon market. Extensive experience has been gained through the array of CDM methodologies developed to date. It could be feasible to build on this to agree guidelines for methodology development and monitoring under the Framework, but without centralised approval of individual methodologies. Elements of the CDM procedures could serve as the basis for guidance, for example flexibility in how baseline methodologies can be developed, including the option for using emissions benchmarks.⁵

(iii) Monitoring standards: Agreed monitoring standards could define requirements for accuracy of monitoring equipment or methods for the actual measurement of emissions. Applying materiality thresholds in monitoring standards for new mechanisms would be a way to improve transparency and comparability across mechanisms, whilst maintaining fairly flexible monitoring requirements. Materiality is a common concept within auditing and accounting.⁶ In the context of GHG accounting, this could mean a threshold for what omissions or errors are significant enough that they have a *material* impact on the quantity of emissions reductions. Until now this has not been permitted for validation and verification of CDM projects. However, the CDM EB has recently issued a draft standard on the use of the concept of materiality in CDM, following on from similar guidance for JI.

A Framework based on transparency agreement with less international co-ordination

Under this option Parties would agree only general principles for mechanisms along with minimum transparency requirements. UNFCCC involvement would be limited to ensuring that sufficient information is disclosed to satisfy these requirements. In this way, units issued from mechanisms that provide the required level of information disclosure and transparency of projects or programmes

⁴ The CDM currently has rules avoiding perverse incentives for introduction of regulation. Any regulation giving comparative advantages to less emissions-intensive technologies introduced since the adoption of the CDM can be excluded from the baseline scenario (so-called E- policies) (EB22, Annex 3).

⁵ Para 48 of UNFCCC Marrakesh Accords, available at <u>http://unfccc.int/cop7/documents/accords_draft.pdf</u>

⁶ The International Accounting Standards Board (IASB) defines materiality as follows: "An information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements." (IASB Framework, <u>www.iasb.org</u>)





would be recognised towards meeting pledges under the UNFCCC process. Such an approach would not in itself ensure consistency between different market mechanisms, but could ensure a minimum level of transparency. This could at least facilitate market valuation of different credits and improve liquidity in the market to some extent, relative to completely uncoordinated mechanisms.

In contrast to the more centralised option described above, this option would not establish any test on the environmental quality of credits and would only stipulate information requirements from which the quality of credits could be assessed. Participating countries would retain responsibility for the environmental integrity of the units generated by the mechanisms, and the aim of the transparency requirement under the Framework would be to encourage countries to undertake the necessary environmental due diligence to ensure that real emissions reductions are achieved. A further level of international comparability could be provided by requiring that verification agencies adhere to non-UNFCCC international standards, such as those described by the International Organization for Standardization (ISO). However, it is not clear that if the Framework were to be based only on general principles and transparency requirements, it would build enough trust between countries to ensure multilateral recognition of units for use towards meeting international pledges. Table 1 compares these two options for governance of crediting mechanisms under the Framework.

	Common criteria for unit recognition	Principles and transparency approach
Description	Through COP, countries agree criteria for unit recognition defining minimum requirements for UNFCCC recognition of units from country-led mechanisms. Mechanisms proposed would need to demonstrate that criteria are met. Criteria could include eligibility criteria (e.g. an environmental quality test), monitoring standards and methodology principles.	Through COP process, countries agree general principles for market mechanisms and minimum transparency requirements. Units could be recognised under UNFCCC provided that countries operating mechanisms disclosure required information. No direct international assessment of unit quality.
Pros	Experience from CDM, including work on standardised baselines, could be utilised in developing criteria for unit recognition. Common criteria and UNFCCC accreditation of DOEs could improve fungibility of units in the market, relative to fragmented system	Greater flexibility in developing new mechanisms which may lead to innovation and new solutions. Could be rapid to put into place because no development of international criteria and/or accreditation standards required
Cons	Common criteria, while less elaborate than CDM procedures, may continue to create bottlenecks for country-led mechanisms. Criteria that are too detailed could reduce flexibility and sector coverage of country-led mechanisms.	Without common standards other than transparency requirements, fungibility of units may be difficult to establish and it may be hard to built sufficient trust for recognition of units by UNFCCC. A proliferation of bi-lateral crediting standards could result in market fragmentation, higher transaction costs and lower investment.

Table 1: Two options for governance of country-led crediting mechanisms under the Framework





Systems for tracking GHG units recognised under the Framework

If units from diverse country-operated market mechanisms are to be recognised under the Framework, effective tracking of internationally-traded GHG units would be important to maintain trust in the use of GHG units to assist in meeting national mitigation targets or pledges. Under the Kyoto Protocol (KP), tracking is performed by the International Transaction Log (ITL) and this electronic tool could also be of use under the Framework. The ITL, in addition to facilitating communication between the unit registries of different countries and keeping a record of transactions, also performs both technical and policy-related checks on proposed transactions before executing them. Recent CCXG analysis⁷ proposed three options for how tracking of GHG unit transactions could be conducted after 2012 outside of the KP. Two options would retain the ITL (or similar device) while the third option features direct registry-to-registry communication only with no centralised recording system. Under all options, developing countries could be encouraged to establish unit registries to facilitate participation in unit-based mechanisms.

The first option would retain a central ITL with the ability to conduct both technical and policyrelated checks on transactions before executing them, as under the KP at present. If units from non-KP mechanisms were to be introduced under the Framework, the policy-related checks could reflect the decisions made by Parties regarding the governance of crediting mechanisms. For example if Parties opt for the "criteria for unit recognition" approach described above for crediting mechanisms, the ITL could check at the issuance stage whether the activity or mechanism concerned has demonstrated adherence with internationally-agreed criteria for unit recognition under the Framework, before allowing the transfer of the units to proceed.

The second option would also retain a central ITL, but without the ability to conduct policy-related checks of transactions. In this scenario, the principal purpose of the ITL would be to record transactions and conduct essential technical checks to ensure the smooth operation of the system. Any transaction proposed between two compatible registries would be carried out. Under this option some international oversight could be maintained if countries agree to submit a one-off or periodic report describing the systems they have put in place to ensure transparency and environmental integrity, before a connection can be established between the ITL and national registry.

The third option for unit tracking would comprise no central ITL or other hub, only direct communication between registries hosted by participating countries. This highly decentralised option would provide maximum flexibility for countries to operate and exchange diverse unit types on a bilateral basis, without requiring further consent by Parties with which they do not trade. However, international visibility of transactions would be entirely dependent on disclosure from registries and it could be difficult for outside observers to determine whether the units and transactions occurring are unique. Therefore this might be a less suitable option for tracking units under the Framework.

Table 2 summarises advantages and disadvantages of these three options.

⁷ Prag, A., C. Hood, A. Aasrud and G. Briner (2011), "Tracking and Trading: Expanding on Options for International Greenhouse Gas Unit Accounting After 2012"<u>http://www.oecd.org/dataoecd/61/35/49101167.pdf</u>





Table 2: overview of three options for tracking unit transactions under the Framework

	Central ITL records and performs technical and policy- related checks on unit transactions	Central ITL records transactions and performs technical checks only	No central ITL; inter-registry communication only, transparency provided by reporting and verification
Description	ITL continues to record and conduct technical and policy- related checks on transactions, based on decisions made regarding the governance of crediting mechanisms and use of international GHG units.	ITL (or new tool) records and performs essential technical checks on transactions with no discrimination of unit types; issuing or buying countries would be responsible for ensuring unit quality and integrity. Could require a one-off or periodic report from countries before connecting to ITL.	Parties choose how to design their registry and which other registries to connect it to, with no UN checks on transactions; reporting and verification of information reported by individual countries ensures transparency.
Pros	Maximum international visibility for quality of units being created and transacted Builds on existing hardware and processes (e.g. helpdesk, data centres)	Retains central recording tool but more flexible to country requirements Partly builds on existing system	Maximum flexibility for countries to use international market mechanisms according to their own circumstances
Cons	Top-down approach and stringent requirements for developing countries may not encourage greater participation Could be inflexible to diverse unit types and market mechanisms	Involvement of UN without control over what passes through ITL might be considered weakening of UN integrity Difficult to ensure comparability of market mechanisms	Potentially onerous demand on countries to ensure full transparency of transactions and sufficient security Potential technical difficulties in communications/ disclosure without central tool and common unit definition





Part 2: Modalities and procedures for a new market-based mechanism, operating under the authority and guidance of the COP, to enhance the cost-effectiveness of, and to promote, mitigation actions (paragraphs 83 and 84)

The COP 17 AWG-LCA outcome does not specify whether the new market-based mechanism will comprise an emissions trading aspect, involving *ex ante* issuance of allowance units with a binding target or cap, or whether it will function as a crediting mechanism with *ex post* issuance of credit units. This submission is made on the basis that the mechanism will operate as a crediting mechanism.

The establishment of a new market mechanism represents only one step towards a more cost-effective international climate change policy regime. Market mechanisms are not an end in themselves but a means to deliver scaled-up global GHG mitigation cost-effectively. In the context of forecasts for weak international demand for tradable GHG units in the coming years, the creation of a new market mechanism to expand the supply of credits will only be successful if accompanied by strengthened mitigation goals to establish robust demand for credits over a timeframe sufficient to drive investment decisions.

Paragraph 83 of the AWG-LCA outcome states that the new mechanism should taking into account certain principles that were defined at COP 16 in Cancun. Whilst some of these principles are already enshrined in the goals of the KP mechanisms,⁸ the following are not: complementing other means of support for nationally appropriate mitigation actions by developing country Parties, stimulating mitigation across broad segments of the economy, and ensuring a net decrease or avoidance of global greenhouse gas emissions.

To achieve these principles, the new crediting mechanism will need to be designed with careful attention to what incentives for participation it provides for both host country regulatory authorities and emitters covered by the scheme. For a crediting mechanism to both stimulate mitigation across broad segments of the economy and ensure a net decrease/avoidance of global emissions, implies that: i) credits would be awarded only if the net aggregate performance of emitters in the "segment" improves on a defined baseline and ii) for the baseline to be set at an ambitious level that clearly includes mitigation effort implemented under the responsibility of the host country. Both of these aspects differ from the CDM which, even with the recent introduction of standardised baselines, rewards individual projects or programmes based only on their own performance against a baseline. With sectoral crediting the carbon market incentive to individual investors in mitigation may be less direct, and therefore weaker than that under a single project configuration like the CDM. Under sector-wide crediting, an entity's good performance can be offset by the lack of progress of other entities in the sector, resulting in low or even zero crediting to the sector as a whole; the entity's efforts could not be fully rewarded by the carbon market in such cases.

Two important design aspects for the new mechanism are therefore the level of flexibility in how the mechanism is implemented in different countries, and the process for setting and reviewing "ambitious" baselines. The modalities and procedures of the new mechanism will need to address these issues amongst others, as summarised in Table 3.

⁸ These include: ensuring voluntary participation of Parties, safeguarding environmental integrity, assisting developed country Parties to meet part of their mitigation targets and ensuring good governance and regulation





Table 3: Possible principles and requirements for modalities and procedures of the new market mechanism

Principles and requirements	Description and key questions
Restrictions on	Would access to the new market mechanism be restricted on the basis of
participation in different	country categories or circumstances? Would CDM continue to operate in
market mechanisms	countries/sectors with access to the new mechanism?
Requirements for	This could be a range of criteria along these categories:
participation	- Environmental ambition of the crediting baseline (e.g. linked to a low-
	emission development strategy or a percentage deviation from
	business as usual);
	- Coverage (minimum share of GHG emissions in the country proposed
	for access to the market mechanism);
	 Institutional capacity for tracking of performance and units
Baseline setting and	Appropriate baselines will be crucial to ensuring successful mitigation under
achieving "net global	the mechanism and achieving net global decrease. Key elements, discussed
decrease"	further below, include:
	- A clearly defined <i>boundary</i> (which installations or entities to be
	covered and monitored);
	- Minimum data requirements;
	 Process for baseline setting/approval;
	- Frequency of baseline revisions
Provisions for monitoring,	MRV provisions could include requirements on accuracy, data quality and
reporting and verification	levels of materiality as well as requirements for use of verification agencies
of emissions reductions	and accompanying accreditation processes
Length of the crediting	A longer crediting period provides some certainty and time to implement
period	changes, while a shorter crediting period allows for adjustments of the
	environmental ambition of baselines
Frequency and modalities	Credits could be issued under national or international authority
of credit issuance	
Interaction with CDM	The LCA outcome states that new mechanisms should build on the existing
	Kyoto mechanisms. Clarity is therefore needed on fungibility of credits as well
	as how existing CDM projects are accounted to avoid double counting of
	reductions if they fall within the (sector) boundary of new market mechanisms
Trading units, registries	CDM provides good precedence in some areas, whereas others, such as
and national governance	management of crediting in a highly heterogeneous sector, may require
structures	significant capacity building; the options described in Part 1 of this submission
	for transaction tracking could also be relevant for the new market mechanism

Flexibility for country-level implementation of the mechanism

The modalities and procedures of the new market mechanism could allow for flexibility in how the mechanism is implemented in different countries. Unlike the CDM, agreement on a baseline for a sector or policy does not necessarily provide immediate incentives for mitigation action at the project/entity level. These incentives depend on how the scaled-up crediting mechanism is implemented at a domestic level – which is likely to vary country-by-country.

An entity that invests to reduce emissions below an agreed country baseline would not necessarily have any guarantee of receiving credits, as these would be issued on the basis of the *overall*





performance. Therefore, to be effective, a broad-based crediting mechanism requires host country governments to introduce policy instruments to move the sources of emissions to a lower-emissions pathway. The government needs to introduce a mix of policy instruments to guide GHG sources in the sector in the right direction and the new mechanism could be designed to provide host country governments significant flexibility as to what policies to adopt to limit emissions below the agreed baseline, and how appropriate incentives are passed on to emitters. Countries may also receive direct support to build and implement lasting and sustainable domestic policy frameworks to participate in any new scaled-up market mechanism. This would be in addition to ("complementing") revenue from the sale of credits to developed country Parties to assist them in meeting their mitigation targets. A range of policy tools, with a more or less direct link to the carbon market, could be adopted by governments to reach NAMAs or sectoral goals; some examples include:

<u>Baseline-and-crediting at entity level</u>: Such a system will not put entities under an aggregate cap, but would allow them to generate credits by reducing their emissions below an intensity baseline level. To implement the system, the national sector baseline would have to be translated into a series of entity-specific baselines. This would ensure that installations were certain to be rewarded for investments they make, but may only be feasible with a limited number of individual players in the sector at stake.

<u>Subsidies and regulatory approaches</u>: A range of policies from subsidies to performance targets at installation level could be adopted to encourage changes needed to outperform the baseline or target. Mandated performance standards for new (and possibly old) installations could also improve the sector/NAMA performance below the baseline. Some of the possible carbon revenues, if the country performs below the baseline, could be used to finance some of the government programmes; they could also be used to reward entities out-performing targets.⁹

Approaches for setting baselines to achieve "net decrease" in global emissions

The existing project-based mechanisms act to improve the cost-effectiveness of meeting Annex I countries' mitigation targets but they do not themselves contribute to a net decrease in global GHG emissions. For new market mechanisms to contribute to a net decrease in emissions, the baseline for crediting in non-Annex I countries would need to be set lower than the business-as-usual (BAU) emission trend in the sector covered by the mechanisms. This would represent a departure from CDM where credits can be generated by any action shown to be distinct from a baseline that estimates a BAU scenario. With a more ambitious baseline, emissions reductions between BAU and the baseline represent the host country's own contribution to global mitigation. The emissions level proposed to represent BAU, and therefore the level of host country contribution, is a counter-factual and therefore difficult to define precisely. This is not solely a technical issue and may require some negotiation.

In such a case, a process for setting and approving baselines would be needed giving clarity over what approaches qualify for baselines put forward for the new market mechanism, and what authorities (national or international) will be called on to review, recognise or otherwise "validate" baselines for use under the new market mechanism. One approach would be for Parties to first agree on a rate of

⁹ Experience shows that policy packages for GHG reductions, even in the presence of a carbon market instrument, can be useful in delivering structural changes (e.g. renewable energy policy support, end-use efficiency policy, etc.)





departure from a (BAU) scenario. Alternatively Parties could decide to discuss the ambition of the baseline directly based on a BAU trend at a country/sector level, without a need to precisely determine the exact BAU trajectory. These options could be described as follows:

- An agreement on a systematic, quantified departure from BAU emissions (e.g. -x% from BAU) would require a process to agree on BAU trends and a separate negotiation on the rate of departure the value of "x" from BAU. One way to achieve this would be a requirement for low-emission development strategies (LEDS) to model forward projection of emissions by sector, with possible international review. An international body, perhaps under the responsibility of the COP, would be needed to assess BAU trends or LEDS. Sector-specific bodies may be needed to assist this institution on technical aspects of sectors.
- An agreement to negotiate baselines on a case-by-case basis without first specifying an exact BAU scenario and a precise deviation from it would require countries or other entities to propose a crediting baseline and justify why it is at an appropriate level for the sector or group of emitters covered. This may imply a more political negotiation, as the magnitude of mitigation ambition on the part of the host country would be less clear. This discussion may also take place as Parties conduct international review of LEDS. Sector-specific bodies may be valuable in this case as well.

Access to robust and reliable data on emissions and sector production is likely to vary significantly by sector and country and this may influence the setting of baselines in difference situations. A clear definition of the mechanism boundary, including which individual entities are included, is also important. This may vary between different countries depending on specific country circumstances. Furthermore, if baselines are to be determined using performance benchmarks relative to metrics such as product output, the actual performance level will vary between countries. For example, industrial structures (the age and distribution of capital stock), domestic access to raw materials and technologies and regulatory obligations (e.g. in price setting) are among factors that would affect the relative performance of countries in any given sector. Thus, a homogenous approach to establishing baselines (*e.g.* via an agreed methodology or guidelines), rather than a single common baseline level, could be developed to take such differences into account.

Launching the mechanism: "market readiness" and demonstration activities

Increasing understanding of the role market mechanisms can play in GHG mitigation efforts could serve as a stepping stone for encouraging uptake of the new market mechanism. A process to improve "market readiness" in a country could involve establishing the necessary technical, policy and institutional frameworks for a country to be able to employ market mechanisms. Part of this process may also involve capacity building and technical assistance in data collection and verification feeding into the baseline setting process. Furthermore, pilot activities may be a useful first step for initiating the mechanism, especially if a credit purchase guarantee is provided. This could follow the model of Activities Implemented Jointly (AIJ) launched at COP 1 and, for REDD demonstration activities promoted at COP 13. Pilot activities need not be initiated directly through the UNFCCC (as was undertaken with AIJ), but could be independent pilot activities which are reported back to the UNFCCC.