

Scaling-up market mechanisms to deliver cost-effective and ambitious climate change mitigation

1. INTRODUCTION

The WBCSD welcomes the decision in Durban, as part of the AWG-LCA, to establish a new market-based mechanism to efficiently allocate private capital towards cost-effective mitigation actions. The WBCSD believes that a critical focus of the Durban Platform for Enhanced Action (DPEA) should be to facilitate the development of an eventual global carbon market, built from the progressive, multilateral linkage of various national, sectoral and project approaches, supported by standardised global measurement, reporting and verification methodologies. The WBCSD outlined this concept, which has at its foundation new market mechanisms, in their 2007 paper *'Establishing a Global Carbon Market: A Discussion on Linking Various Approaches to Create a Global Carbon Market'*¹.

The proposal outlined below is a technical elaboration of this paper that provides further detail on one option for a new market mechanism that will facilitate this multilateral linkage. The idea is to create a *flexible framework* that builds on the current bottom-up process of *nationally appropriate mitigation actions* (NAMAs) supported by an *international carbon market*. Countries and/or sectors, seeking to increase their ambition levels and achieve least-cost abatement, would be able to utilise the carbon market on an "opt-in" basis either through a crediting- or a trading-based mechanism or through both. The main aim of this system would be to foster private investment in the low-carbon economy and enable the least-cost, large-scale emissions reductions required to satisfy increased ambition levels. A successful international carbon market requires both a supply of credits, and a demand through ambitious mitigation goals. Such a bottom-up approach that allows for the optional participation in an international carbon market can then be expanded over time to support the scaling-up of mitigation efforts and to more effectively mobilise private investment.

About the WBCSD

The World Business Council for Sustainable Development (WBCSD) is a unique, CEO-led, global association of some 200 companies dealing exclusively with business and sustainable development. The Council provides a platform for companies to explore sustainable development, share knowledge, experiences and best practices, and to advocate business positions on these issues in a variety of forums, working with governments and non-governmental and intergovernmental organizations.

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This submission is released in the name of the WBCSD. Like other WBCSD publications, it is the result of a collaborative effort by members of the secretariat and executives from several member companies. A wide range of members reviewed drafts, thereby ensuring that the submission broadly represents the majority view of the WBCSD membership. It does not mean, however, that every member company agrees with every word.

¹ <http://www.wbcasd.org/Pages/EDocument/EDocumentDetails.aspx?ID=14341&NoSearchContextKey=true>

2. RATIONALE FOR MARKET-BASED MECHANISMS AND THE ROLE OF A CARBON PRICE

The main aim of market mechanisms is to put a price on carbon to foster private climate investment including in developing countries and increase carbon finance flows. The use of market mechanisms can increase the cost-effectiveness of mitigation and enable ambitious mitigation action as the introduction of a carbon price incentivises market participants to discover and implement least cost abatement options within the scope of their operations. This increased cost-efficiency then incentivises both countries and/or sectors of the economy to increase their ambition levels in terms of emissions reductions. This will be supported further, once an international agreement on climate change is negotiated under the DPEA, as global targets are likely to be set.

At present, carbon pricing is being introduced piecemeal throughout the world. This is resulting in less efficient abatement, unclear price signals for private investment and increased risk of carbon leakage which can jeopardise global emissions reductions. It is essential that a framework is put in place that allows for multilateral participation in a global carbon market that can link divergent national systems to incentivise private sector investment, ensure lowest cost abatement, and create a level playing field. Carbon pricing should be encouraged as part of national government mitigation plans throughout the economy, but especially in the industrial and power sectors. Even if set at a nominal level, this will help in the development of the systems required to participate in a global carbon market.

3. LESSONS FROM THE UNFCCC MECHANISMS AND THE IMPORTANCE OF SUPPLY AND DEMAND

The development of a new market mechanism should build on lessons from the current structures under the Kyoto Protocol, including the Clean Development Mechanism (CDM). Whilst the current system has its challenges, there are a number of best practice lessons that can be taken from its inherent design. The system was set up in such a way to create both demand and supply. Demand came from the targets set under Kyoto and the ex-ante allocation of allowances called Assigned Amount Units (AAUs), while the CDM created a steady supply of credits that could be used by developed countries to help meet their emissions targets. Lessons have been learned, for example the setting of baselines to determine AAU allocations was not ambitious enough leading to some countries having an oversupply of AAUs and bringing the integrity of the system into question. Setting stringent baselines and ambitious targets must be a priority of any new market mechanism. A further element, critical for future mechanisms was the emissions accounting rules which allowed fully fungible credits, despite a slightly cumbersome process.

The CDM has been important in allowing developing countries to participate in the carbon market and providing them with financing for clean technology. Many lessons have been learned from its weaknesses which now need to be heeded. The project-based CDM does not promote the changes on the scale necessary to encourage the transition towards low-

carbon economies. The challenges in proving additionality and the ineffectiveness of the registration process for CDM projects pose major barriers to scaling-up the current system. As a result, a future crediting mechanism must move away from general additionality criteria and allow for differences between countries and sectors, as well as ensuring the application of standardised methodologies for assessing projects. New market mechanisms should also be geared towards large-scale emission reductions across whole sectors of the economy rather than on individual projects or installations.

Other important lessons can also be drawn from domestic or regional emissions trading systems (ETS) such as the European Union's ETS (EU ETS). The EU ETS has enabled the EU to meet its emissions reductions goals at the least-cost to society due its design which is based on a cap-and-trade approach. This is because the cap ensures a guaranteed environmental outcome and the trading element of the system enables abatement to occur where the cost is lowest.

4. CASE STUDY—THE BUILDING BLOCKS OF AN INTERNATIONAL CARBON MARKET

a. Bottom-up development of nationally appropriate mitigation actions (NAMAs) within an international Framework

The WBCSD proposes a framework for the linkage of diverse regional and national policy approaches. The example below outlines a possible way of operationalising this framework and defines one type of market mechanism that could be utilised. The WBCSD approach is based on developing NAMAs at the country and/or sectoral levels that have different financial structures. For the purpose of this paper, and for the sake of moving away from the developing / developed country divide, the NAMAs concept is expanded to include all sets of mitigation actions that any country/sector chooses to develop. This could range from economy wide cap and trade in the EU to rural solar electrification in Kenya. In terms of financing, developing country NAMAs would either be financed domestically, supported through funding, capacity building or technology development from developed countries or the Green Climate Fund (GCF), or through the international carbon market (Figure 1). Developed country NAMAs would not be eligible for funding from the GCF but could make use of the international market through NAMAs trading. Those NAMAs funded through the carbon market would be subject to oversight by a UNFCCC '**Carbon Market Executive Board**' (CMEB). The role of the CMEB will be explained later in the paper.

This approach builds on the current *bottom-up, pledge and review* framework, whilst also establishing an international accounting system that will present countries or sectors of the economy with the 'option' to link their approaches through utilising a global carbon crediting and trading system. The system would have the potential to build quickly to a global market that would align with the eventual international climate change agreement being negotiated under the Durban Platform for Enhanced Action. The flexibility of this approach takes into account the different capabilities of countries.

Financing Structure	Unilateral NAMAs	Supported NAMAs	Credited NAMAs	Traded NAMAs
Description of Operation	<p>Fully funded by the host country without international support.</p> <p>The emissions reductions from this NAMA are verified domestically.</p> <p>Emission-reductions resulting from this type of NAMAs counts towards the host developing country's emission reduction pledge.</p>	<p>Receive direct support from the GCF or developed countries through funding, technology and / or capacity building.</p> <p>The emission-reductions from internationally supported NAMAs is verified with international guidelines but cannot generate carbon credits.</p> <p>The emissions reductions from this type of NAMA counts towards the host developing country's emission reduction pledge.</p>	<p>Generate carbon credits for offsets to be sold directly to countries to comply with their emission targets or sold to the carbon market.</p> <p>A country defines a segment of the economy. The emissions of this sector will be checked against an agreed threshold (below a business-as-usual baseline) for this sector. If emissions are below this crediting threshold, emission credits will be issued, which can be sold on the carbon market to meet other countries compliance. If the crediting threshold is not met, no penalties will be imposed (a no-lose target) and the emissions below the BAU will still count towards the country's emissions reduction pledge.</p> <p>This will work similarly to the CDM but at a sectoral, rather than at a project level.</p>	<p>These are NAMAs that are aligned with an ex-ante absolute cap for a sector of the economy that is set by a country and then reviewed by the CMEB to ensure the cap is sufficiently ambitious.</p> <p>The CMEB will then allocate allowances (NAMA Allocation Units or NAUs) equal to this 'cap'. At the end of the year, the country must surrender the number of allowances equal to their emissions.</p> <p>Countries can then either sell excess allowances or buy extra allowances on the market if emissions exceed the absolute target</p>
	UNFCCC Support	<p>Countries are recommended to follow UNFCCC guidelines for MRV but they are not subject to any formal 'checks' by the UNFCCC.</p>	<p>Supported NAMAs will need to follow some basic level of international MRV requirements if support is sought from the GCF.</p>	<p>Both credited and traded NAMAs will be subject to the conditions outlined by the 'Carbon Market Executive Board' that will ensure sufficient ambition level and the fungibility of units / credits.</p>

Figure 1: Funding Structures for NAMAs

Countries can choose to implement NAMAs for different sectors of their economy that make use of one or more of the various funding mechanisms. The choice of funding mechanism will depend on the range of mitigation options available (i.e. availability of ‘low hanging fruit’ versus more costly mitigation options) and the capacity and resources available to a country to implement the various approaches. Countries or sectors of the economy aiming to mobilise private financing through either developing a ‘credited NAMA or a traded NAMA’ utilising the international carbon market, will be subject to the requirements of the centralised UNFCCC oversight body, the CMEB. A credited NAMA would function in a similar way to the Clean Development Mechanism (CDM) but at larger scale (i.e. covering a sector (s) of an economy). A traded NAMA would work similarly to the current system. The CMEB would allocate NAMA Allocation Units (NAUs) to countries based on a pre-determined emissions target for the particular sector covered by the ‘traded NAMA’. In other words, the ‘cap’ would not be set for the entire country, but only for a particular sector of the economy that the traded NAMA covers. The country would then allocate NAUs to industry in that sector through an agreed domestic process. Traded NAMAs would be utilised by countries wanting to increase their ambition levels, maximise cost efficiency and access private financing at a large-scale. The CDM, as a project-based mechanism, would continue to operate within this framework as an offsetting mechanism only to be used by least developed countries.

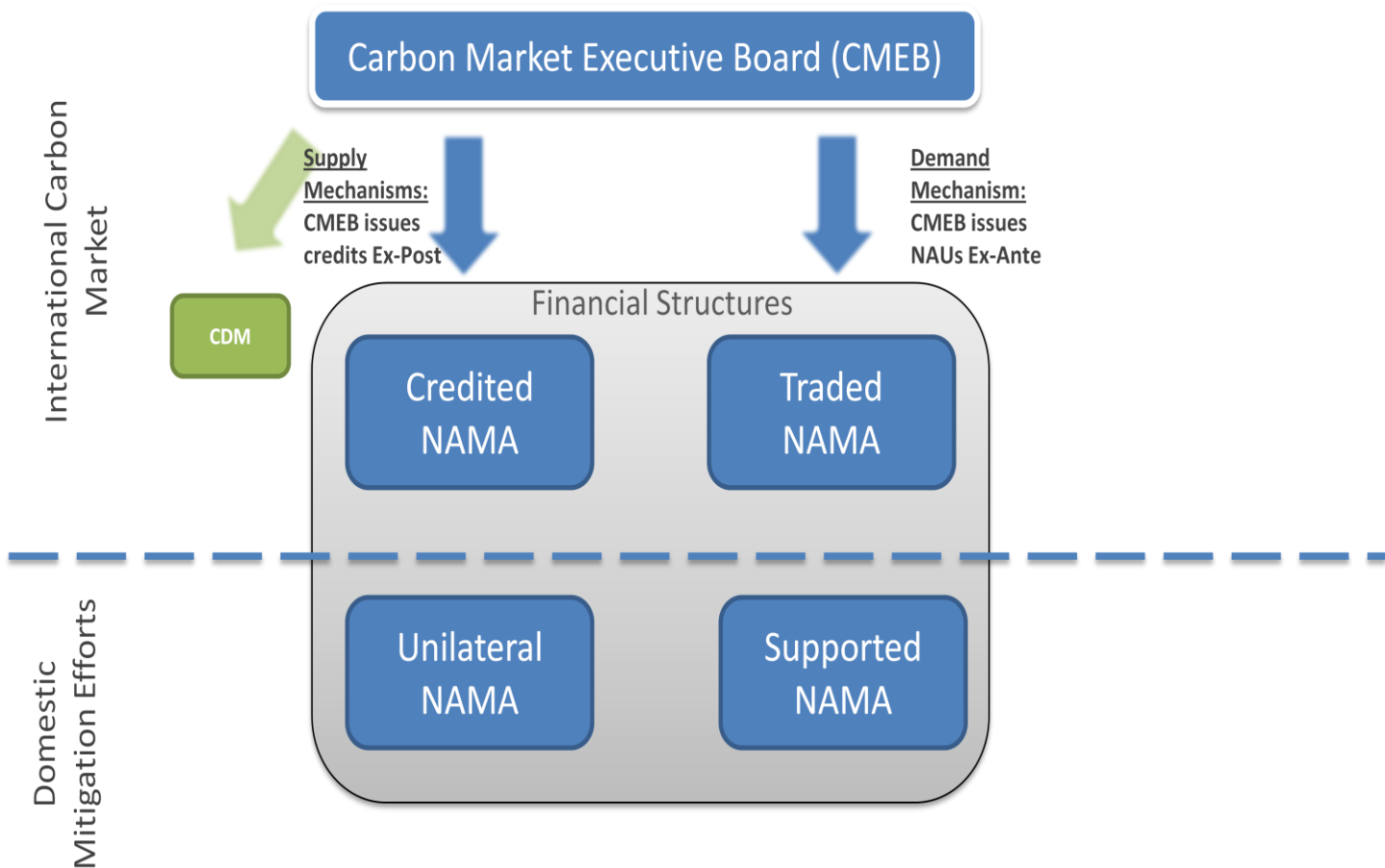


Figure 2: Proposed Structure of the International Carbon Market

b. Role of the UNFCCC oversight Body—the Carbon Market Executive Board (CMEB)

Clearly, the role of the Carbon Market Executive Board (CMEB) will be critical to the transparency and rigor of the emission caps set by each country. While the country should have some level of discretion in how it sets a cap, across whichever sector of its economy, the CMEB will need to have very strong oversight on MRV. This is essential to ensure that emission-reductions from diverse sectors and countries are (1) real, (2) verifiable, and (3) additional to any business-as-usual pathway of emissions.

The roles and responsibilities of the CMEB will need to be clearly defined but must include:

Defining and reviewing eligibility criteria

The CMEB must establish *strict criteria* for allowing a country and/or sector to utilise one of the mechanisms (crediting or trading) under the international carbon market. This will include stringent MRV and defining ‘**ambitious**’ baselines (or crediting thresholds) to ensure that real emissions reductions are made and the environmental integrity of the system is not jeopardised. For example, setting the threshold below business-as-usual emissions would ensure that emissions reductions that are towards the higher end of the cost curve are credited leaving lower cost solutions as those to be done by countries as part of their unilateral NAMA or supported NAMA. Stringency of baselines/crediting thresholds should also reflect respective countries capabilities to undertake their own action. So a developed country would have a much more stringent threshold than a developing country. These thresholds must be periodically reviewed by the CMEB.

Second, the CMEB must *develop a process* which determines which countries and sectors qualify to use which mechanisms. For example, a developed country cannot submit a *credited NAMA* and an emerging economy cannot host a CDM project. This qualification must also be reviewed periodically to ensure that countries can transition from one category to the next.

Defining standards for MRV

The CMEB must set clear methodologies and standards for monitoring, reporting and verifying (MRV) emissions. This is essential to ensure that emission-reductions from diverse sectors and countries can be converted into internationally fungible credits. This is essential to ensure that emission-reductions from diverse sectors and countries are (1) real, (2) verifiable, and (3) additional to any business-as-usual pathway of emissions. The CMEB must have a critical role in evaluating the business-as-usual pathway of emissions growth of a particular country and the covered sector.

Issuing credits and NAUs

The CMEB is responsible for the issuance of credits (for both credited NAMAs and the CDM) and the issuance of ex-ante allowances (NAUs) for traded NAMAs. These should be listed in the NAMAs registry that was agreed to be established in Cancun.

Ensure adherence to a set of principles

The CMEB needs to ensure that the international carbon market (that includes both crediting and trading systems) adhere to a number of basic principles. These principles should include the following:

a. Optional participation allowing flexibility

Participation in the international carbon market is optional and would form part of a country's efforts to reduce emissions. The decision to participate using either a credited NAMA or a traded NAMA will be a policy decision of an individual country. It is envisioned that developed countries, that have exhausted lower-cost options, will utilise the international market (either as a buyer of credits or to trade NAUs) more than a developing country that may choose to develop unilateral or supported NAMAs predominantly. If countries decide to utilise the market as part of one of their NAMAs, then once signed up, compliance becomes mandatory.

b. Stimulating mitigation across broad sectors of the economy

The international carbon market should cover a broad sector of the economy and not be limited to any specific sectors.

c. Safeguarding environmental integrity through robust emissions accounting

The environmental integrity of the system must be maintained through robust MRV to avoid double counting and carbon leakage. Ensuring that countries meet certain standardised MRV requirements is essential to ensuring the fungibility of credits or units.

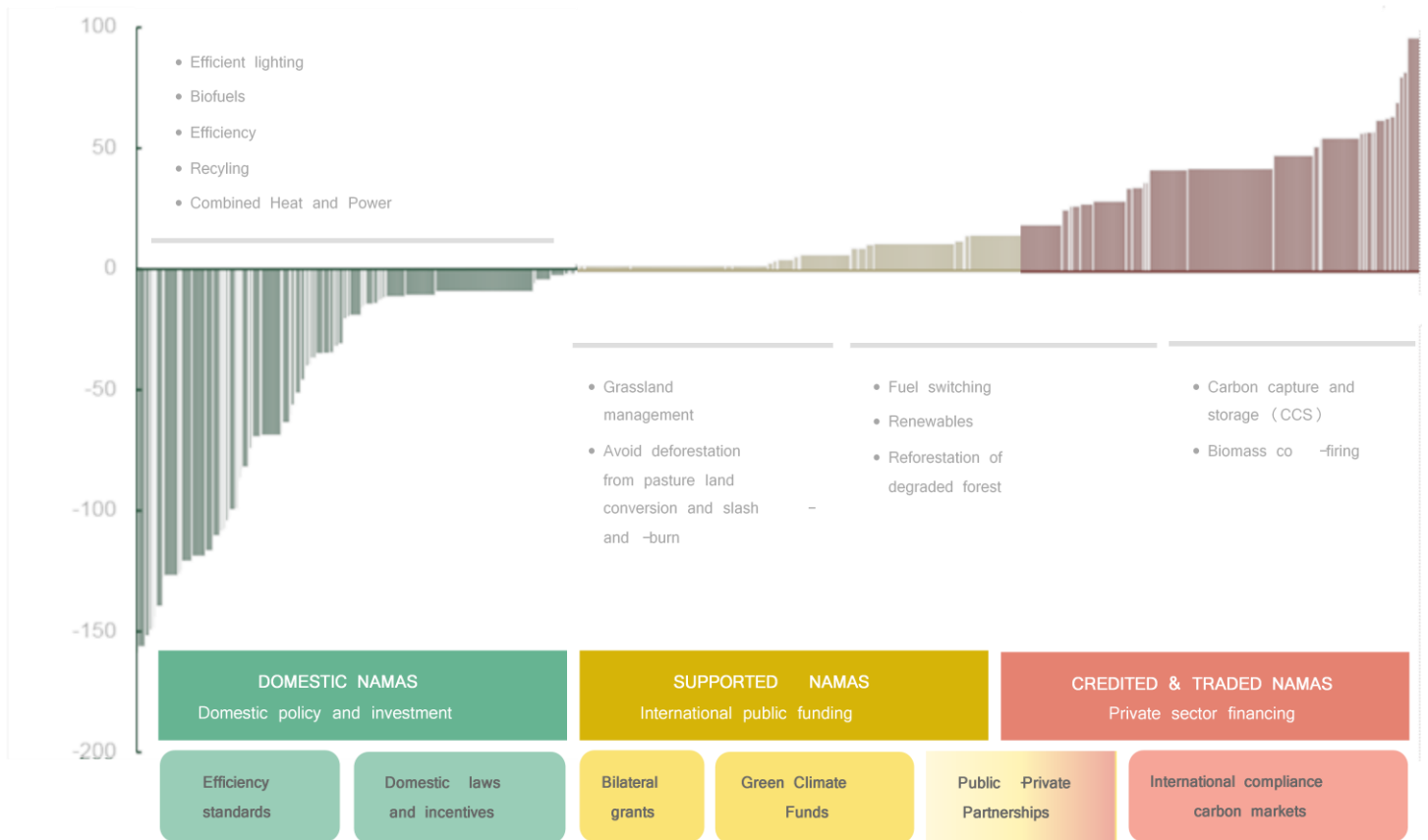
d. Ensuring a net decrease and / or avoidance of global greenhouse gas emissions

It is essential that the main goal of achieving a decrease in GHG emissions is maintained. This can be achieved by ensuring that the credits or allowances are allocated against an ambitious crediting threshold that is below *business as usual* emissions.

e. Supplemental to domestic mitigation efforts

The international carbon market will be supplemental to domestic action. Some NAMAs (for example, unilateral and supported NAMAs) will not be linked to the international carbon market and will not be either assigned NAUs or generate emissions credits. However, the international carbon market can be utilised by those countries that have existing international emissions reduction obligations to reduce the cost of compliance.

Box 1: An Illustration of how NAMAs could be synchronised across the economy utilising various financial structures



As illustrated by the above diagram, there are certain sectors of the economy that are likely to be more suited to NAMAs that are implemented and financed domestically. These NAMAs will largely focus on lowest cost abatement options such as measures to improve energy efficiency and may, or may not, lead to overall emissions reductions. In most cases, the technology is already available and its implementation is largely a matter of improved housekeeping at the national level. Most countries will implement some mitigation actions such as these without any form of support from the carbon market or from funding sources. However, a country may decide to seek external funding from the GCF or technology transfer from developed countries (i.e. through a supported NAMA) to support the development of low-medium cost mitigation options. Only developing countries should be eligible to get funding as part of their supported NAMA.

Credited and Traded NAMAs both require the driver of a carbon price or equivalent measures and the need to mature and implement technology that may not be readily available or even accessible domestically. These parts of the abatement curve broadly cover the areas of power generation and the provision of fuels in the transport sector. This is where a future international agreement can be most effective in driving change and reducing emissions on a large scale. In the absence of this agreement, countries will still choose to utilise the market in order to increase their ambition levels, to enhance cost effectiveness, and to attract private financing. Developed countries that have exhausted many of their lower cost abatement options, are likely to develop traded NAMAs for large sectors of their economy.

As countries and sectors develop and mature over time, more and more sectors of the economy will be covered under the 'traded' or 'credited' sector, leading to the eventual emergence of a global carbon market.