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**Submission on New Market Mechanisms**

**Introduction:**

- KfW highly welcomes the decisions taken in Durban at COP 17 on the establishment of a New Market Mechanism (NMM). Designed and implemented carefully it would be capable to contribute to cost-effective mitigation and therefore NMM may contribute to the overall objective to limit global warming to 2°C.

- In line with paragraph 79 of the decisions of AWG-LCA, KfW is convinced that standards applied in this regard need to deliver real, permanent, additional and verified mitigation outcomes, avoid double counting of effort, and achieve a net decrease and/or avoidance of greenhouse gas emissions.

- KfW is convinced that market mechanisms can play a crucial role in future global climate change mitigation as they are a key anchor for private sector involvement. The private sector is considered indispensable in order to mobilize the scale of financial flows needed for the transformation of entire sectors and economies towards low carbon development.

- The global scale of emission reductions has to rely on private carbon finance through market instruments and public climate finance which are not considered competing but complementary sources for the funding of mitigation.

We structure our input according to the following: 1) key experiences from CDM and JI and conclusions for NMM, 2) views on Modalities and Procedures including the governance architecture, and 3) the relevance of early NMM piloting,

## 1. Build on key experiences from CDM and JI and conclusions for NMM

Substantial experience exists around the globe which underlines the positive effects but also challenges for market instruments[1]. From a viewpoint of a development bank that has supported the project based mechanisms since times prior to the entry into force of the Kyoto Protocol, experience may provide important lessons learnt for the establishment of NMM:

- **Market mechanisms trigger private sector investments but rely on a robust framework:** Especially the CDM has shown that substantial private investments can be mobilised in comparatively short time, if market participants can reliably expect future revenue streams from carbon finance over significant time spans. On the other hand, a lack of certainty on the continued existence of market mechanisms and especially demand for credits from such mechanisms converts into risks for investors and slows acceptance of market based approaches. Furthermore, certainty and predictability in the regulatory framework is relevant to create bridges in financing. As carbon credits materialize ex-post to the achieved emission reductions the certainty in such a revenue stream will decide if projects and programmes manage to raise e.g. financing based on expected carbon revenues. **With a view to NMM, it will be important to create a mechanism operating over prolonged timeframes, contributing to reliable and long-term incentives created by carbon finance. Especially in an early phase of NMM, risk mitigation instruments are needed which enable investors to overcome risk hurdles and allow to incorporate carbon finance in early stages of investment decisions.**

- **Predictability in operation of market mechanisms is critical**: Market participants are sensitive to changes in rules and processes within the course of operation of a defined mechanism. Furthermore, any given system and mechanism is limited in its capacity to digest change and reform while up and running. **With a view to NMM, it will be important to create a stable set of rules and a robust governance structure, contributing to predictability in operation and performance of the system.**

- A flexible scope is needed for a market mechanism to mobilise its promise: Market instruments will trigger an (intended) dynamic towards identifying options of minimal abatement costs within a defined area. The actual nature in emission reductions, including aspects of environmental and social integrity, depend on the categories of mitigation declared eligible (boundaries). As per definition of market instruments, the various types of mitigations will not be fully foreseeable at start. **With a view to NMM, it is considered relevant to confront potential uncertainties on quality by a gradual expansion in scope over time. The less complex segments of economies and NMM categories could serve as early starting point.**

[1] For instance, the Executive Board of the CDM provided a comprehensive analysis on the CDM prior to COP 17, which is available at: http://cdm.unfccc.int/about/dev_ben/pg1.pdf

- **Carbon finance requires a transparent regulatory environment**: Projects under the CDM and JI mechanism have partially not materialized due to lacking financial closure. Carbon revenues usually materialize ex-post to the achieved reductions (payment on delivery). This has troubled e.g. the collateralization of loans for the actual investment. One of the reasons for the little upfront financing activity being seen in the CDM is the high degree of regulatory uncertainty (both with respect to the project cycle and with respect to continuity and eligibility as a compliance instrument). While NMM will certainly differ significantly in design and face an increased role of the host countries, the challenge to create an environment that enables investors to develop solid opinions on the risk they actually face will remain.
**With a view to NMM, the capacity to raise funds from investors (also prior to GHG mitigations being achieved) will be decisive. To achieve this, rules for NMM need to be transparent and reliable, with regulatory risk being reduced to a possible minimum (ideally through efficient regulations or through risk mitigation instruments that enable investors to overcome risk hurdles).**

In conclusion we believe that these experiences may serve as overarching and guiding principles for the design of new market mechanisms.

**2) Views on Modalities and Procedures including the governance architecture.**

- **NMM driven by Parties and private sector:** NMMs will be proposed and implemented by Parties. The private sector would participate mainly indirectly through engagement within host countries and their NMMs. However, entrance windows for the private sector will be essential for acceptance, up-scaling and mitigation impact. Such entry windows will have to cater for the compliance purposes of the private sector.

- **Start with sectors of limited complexity:** We believe that in an early stage it would be important to start with segments of economies that are less complex. These could include segments and sectors which may be covered with robust MRV at reasonable cost and effort. We would assume that this could e.g. include energy production, certain energy intensive industries, or also (public) transport.

- **Development of MRV Guidelines is an essential prerequisite for a NMM**: MRV guidelines are a cornerstone of the new mechanisms. A wide variety of national mitigation actions with differences in complexity may exist. The most robust MRV system emerges where it is possible to monitor emissions down to the plant level. In many instances, however, it may only be possible to account for emission reductions in the aggregate on the sector level. KfW believes that MRV requirement will therefore depend on the design of incentive schemes using a range of instruments. It will be necessary to allow for aggregated and e.g. sector wide MRV approaches in order to achieve an overall upscaling in emission reductions.

- **New but fully fungible reduction unit to be established**: For the purposes of a newly installed NMM an emission reduction unit (e.g. **New Mechanism Unit / NMU**) is considered necessary, which, for matters of consistency, should be fungible with other established carbon units under the Kyoto Protocol.

- **Plan for a transition from crediting to trading:** In light of the experience in developing countries, KfW believes that it will be in many cases (sectoral) baseline / crediting or trading approaches which have likelihood for success in implementation, especially during early years of operation. Crediting approaches could also serve as a stepping stone for trading approaches. A clear perspective for a transition is required to achieve the necessary long term mitigation targets on a global level.

- **Facilitate a combination of crediting approaches with other policy instruments:** With a view to the actual trigger for mitigation actions within a broad segment of the economy of a developing country, the following categories exist: a) directly carbon related incentives are granted e.g. to the specific plant operators in form of credits, or b) indirectly carbon related policies implemented by the government, such as the introduction of standards and regulations, taxes and charges, subsidies and other market and non-market based incentives (e.g. feed in tariffs, energy efficiency certificates etc). Under b) broarder policy measures could be financed based on revenues from the sale of carbon credits (through national entities).
Directly carbon related incentives schemes, which reward actual performance e.g. at the plant level would –from an investor's point of view- have the advantage that the actual success in the plants mitigation efforts will be directly rewarded with a corresponding amount of credits as return. This would benefit the typical private sector investment approach, which bases its investment decision at the project level and not at the sector level. However, approaches which allow the use of a boarder set of instruments as set out under b) above will play an important role in host country directed efforts towards sector transformation.

- **A Transparent process to set baseline and crediting thresholds is needed:** The definition of e.g. (historic) baselines and crediting thresholds will be complex and is an inherently political notion. Close interaction and input by the Parties will be highly relevant in the definition of baselines and especially crediting thresholds, considering the incorporation of their national efforts to mitigation. We would like to draw the attention of policy makers to the fact that i) challenges around data quality can usually be largely mediated by conservative assumptions, ii) that the CDM, which has made substantial steps forward towards standardization on sector level during the last years and months of reform, may serve as important reference point also for NMM, iii) that the discussion around REDD and the definition on national reference levels may include some further lessons learnt with relevance to NMM. Finally, we believe that the details on baseline and crediting thresholds are best attended if analysed and approved on a case by case basis by the structures and bodies yet to be installed.

**3. The relevance of early NMM piloting**

With a view to a potential roadmap towards making NMM operational, COP17 has provided indications on this matter: i) a decision on the **Modalities and Procedures (M&P) is targeted for the end of 2012 (COP 18)**, ii) a **new legal agreement is expected to be developed by 2015**, and iii) such a new agreement may be sustained with **targets by developing countries by 2020**. Furthermore an amendment of Art.3 of the Kyoto Protocol was proposed by COP17, which could lead to the use of NMM credits for compliance under the Kyoto Protocol. The proposal would require the involved Parties to be part of a capped system (either KP or new agreement).

- KfW considers **a prompt start of NMM is of essence** in order to maintain the momentum of market mechanisms**.**

- KfW recommends that the time from a decision on the Modalities and Procedures until the formation of a new agreement (and possibly beyond) is used for preparation of such mechanisms within host countries and **for an early phase of actual operation (starting as early as 2013).**

- A key challenge for such a pilot phase would be the lack of international demand for NMM credits. Given their non-existence to date, NMM credits are not eligible under the Kyoto Protocol or the EU-ETS. For the purposes of a NMM-piloting phase the necessary funds could be provided by the public sector in Annex I countries via grant funding and cancellation of credits. This approach would i) be limited with respect to the amount of available funds and ii) would not make use of the capabilities of the private sector during this important design phase. In addition to efforts of the public sector and in order to incentivize the private sector to participate in a NMM-piloting phase it would be necessary to furnish the private sector with a compliance instrument or another fungible asset in return for the investment. A relevant approach could be to establish through a (limited) eligibility window for NMM credits. Parties to the Kyoto protocol could be allowed to use a limited volume of NMM credits (e.g. from Parties with a no-lose target in defined sectors). In this manner investors could be furnished with compliance credits (either on UN level or within national trading schemes) in return for verified NMM credits in which they have invested.

We trust that these views and considerations contribute to the international dialogue on New Market Mechanisms, and foster the incorporation of market based approaches to climate change mitigation and sustainable development.

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