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Submission on New Market Mechanism

Introduction

KfW appreciates the opportunity to share and specify its views on the New Market Mechanism (NMM) as defined by COP17 (2/CP.17, para. 83). The following is to be considered in conjunction with our earlier submission on NMM, dated 2 March 2012.¹

The use of market based approaches and the involvement of the private sector in addition to public climate finance streams is considered crucial in order to give the world community a chance to meet the overall financing needs for mitigation and to remain on a 2°C pathway (e.g. WB 2009, IEA 2008, Stern 2006). Mitigation in general and mitigation via markets and private sector involvement in particular is a matter that requires prompt and increased efforts.

With the present input we concentrate on further details regarding the potential role of a prompt start for NMM. For our views on the modalities and procedures for NMM as well as lessons learnt from CDM/JI we refer to the above mentioned submission, dated 2 March 2012.

The relevance of a prompt start of NMM

KfW considers a prompt start of NMM decisive in order to maintain the momentum for market mechanisms. We therefore propose that the time until finalisation of a new agreement² is used for early implementation of NMM.

In order to make a prompt start possible and considering that a fully fledged NMM is likely to take significant time (e.g. for installation of boards, development of rules beyond Modalities and Procedures, etc), we propose to establish defined starting points for controlled early action. In order to maintain trust in market mechanisms, prompt start activities should be initiated in a timely manner, notwithstanding possible delays in the finalisation of the regulatory framework. We underline that the start windows established below are to be understood as a sequence of starting points for NMM activities, which reflect different and gradually advancing development stages of the regulatory setup for NMM. The concept follows a gradual expansion of NMM activities in line with the evolution of rules and agreements.

While it is considered essential that there is at all times a concrete perspective towards the generation of compliance grade credits, the actual issuance of carbon credits and final quality control for activities started within these windows would occur at later stages, when a significantly more advanced or even the full regulatory setup is established. Nonetheless, it will be essential to give maximum possible security to the implementers and investors of prompt start activities.

¹ KfW submission, dated 2 March 2012 available at <http://unfccc.int/resource/docs/2012/smsn/ngo/169.pdf>

² For simplifications we use the term "agreement"; Durban decisions refer to: *protocol, another legal instrument or an agreed outcome with legal force.*

I. Entry windows for prompt start

Window 1: Up to the finalisation of the regulatory setup and a new agreement

An early phase of prompt start of NMM could build upon the following:

- With respect to approvals and the bodies involved (while detailed rules and processes are still in elaboration), emphasis could be given on case by case approvals based on modalities and procedures and, on an interim basis, use elements of the established institutional setup under UNFCCC, such as e.g. review teams for national communications or the CDM Executive Board.
- With respect to MRV, selected methodologies and standardized baselines of the CDM could build the basis for elaboration of prompt start NMM approaches. As part of the CDM reform processes, they have been developed specifically for broader application on sectoral level and furthermore may also be capable to incorporate elements of ambitious baselines.^{3 4} Hence, we would see the potential to cover the Cancun principles on NMM based on curving out and refining selected sectoral elements of the MRV framework established under the processes of CDM reform.
- With respect to scope, it could be started with defined sectors or technologies of lower complexity, which then could be expanded at later stages (e.g. initially excluding sectors potentially exposed to international leakage).
- Options for incentives and crediting of activities during prompt start are described in more detail in Section II below.

Window 2: From finalisation of a new agreement until its entry into force

We see a subsequent phase of NMM evolution starting at the finalisation of the new agreement (scheduled for 2015) up to the point of entry into force of such an agreement.⁵

In this second phase of prompt start implementation, NMM would count with finalized rules and regulations for which we described key elements in our previous submission (referring e.g. a new unit type, MRV on sector and installation level, instruments and incentive structures, etc.). Lessons learnt gathered in a first phase of prompt start may also have contributed to a sound basis for this second phase of scaled up NMM implementation.

- With an international agreement elaborated at this point, security for participants in NMM activities would increase as it would become clearer how NMM is embedded in this new structure and how NMM relates to other market and non-market based mechanisms.
- Complementary to allowing Parties under the Kyoto Protocol to use NMM credits in a second commitment period,⁶ Parties under the new agreement could be allowed to gain credits from NMM starting as early as from the time of finalisation of a new agreement onwards (e.g. 2015). This would result in an early crediting option for NMM and provide an incentive to engage further into mitigation at early times.
- Options for incentives and crediting of activities during prompt start are described in more detail in Section II below.

³ Compare e.g. the publication by INFRAS (2012): [CDM baseline approaches for POA upscaling and new market mechanisms](#)

⁴ E.g. turning off the existing E+/E- rules under the CDM and actually considering policy impacts on baseline setting may already contribute to options for the incorporation of host country ambition in the definition of crediting thresholds for early NMM activities.

⁵ Ratification processes for the agreement will nonetheless take substantial further time after 2015. It is expected that private sector players interested in NMM would not get involved at scale until a new agreement has also formally entered into force.

⁶ Amendment of Art. 3 of KP as decided at COP 17

Window 3: NMM fully established

This entry window would represent full scale operation of NMM under a new agreement. It would build on the experiences from the earlier entry window 1, in which prompt start NMM is initiated at limited scale and a partially still incomplete final setup for NMM, and entry window 2, in which NMM is applied at larger scale not only under the Kyoto Protocol but also as part of early crediting under a new agreement.

II. Options to foster prompt start

1. Incentives to demand

A key challenge for a prompt start would be the lack of international demand for NMM credits. We see two options of different relevance and scale to confront this challenge:

A. via public funding for emission reductions

For the purposes of a prompt start, funding could be provided by the public sector in Annex I countries via grants. These could be used for performance based payments that reward emission reductions achieved through measures eligible to a future NMM (as well as support in implementation, capacity building, etc.). NMM credits eventually emerging could subsequently be retired.⁷ This approach would result in a simulation of NMM with public means while the market is still absent.

In light of the dimension of financing needed even in an early phase of NMM and considering scarce public funding, the feasibility and relevance of this path is likely to be limited. Hence, this approach would be i) limited with respect to scale and mitigation impacts and ii) would not make use of the capabilities of the private sector during the start up and design phase.

However, public payments for achieved emission reductions may be an appropriate path for selected cases of representative early stage examples for NMM, predominantly during the first entry window as described above. These examples could demonstrate how carbon linked incentives can assist in transforming segments of economies and thus provide valuable learning examples prior to a full scale implementation.

B. via defined eligibility windows

Condition for implementation of prompt start NMM at reasonable scale is that corresponding credits will have a market value. For that it needs to be established or at least reasonably likely that they will become a compliance instrument a) under the second commitment period of Kyoto Protocol; b) under the new upcoming agreement; or that they are c) linked to existing or emerging national or regional cap-and-trade systems.⁸

The basis for this would be that there are clearly defined rules for the use of NMM credits by Parties to the Kyoto Protocol and at a later stage also Parties to the new agreement as compliance instrument under the respective protocol or agreement. The modalities for prompt start and, if required, a cap to the use of NMM credits could be defined for each prompt start window.

With regard to incentives for the private sector to participate actively in NMM, it would be necessary to furnish the private sector with compliance credits or another fungible asset in return for their investment in NMM. Private sector involvement is considered crucial for meaningful up scaling of mitigation efforts and should therefore be a key element of the prompt start of NMM.

This option is considered to be vital and applicable for all entry windows, with limitations however during the early phase of entry window 1.

⁷ Performance based payments from public sources for early NMM examples may also formally classify as supported NAMAs with a very robust MRV.

⁸ Purely domestic market based mechanisms are not assumed to classify as NMM.

2. Increasing certainty during a prompt start of NMM

A. via inclusion of early crediting to the regulatory setup

Especially with regard to the second entry window described above, applicable to times after finalisation of a new agreement but prior to its entry into force, attractiveness of NMM to investors could be increased by incorporating an early crediting option.

Early crediting for NMM could also be a relevant to promote NMM under the Kyoto Protocol's second commitment period.

B. via risk sharing and public funding

Public funding may be used very effectively to incentivise and leverage private sector investment into NMM, e.g. via the provision of guarantee instruments or other risk sharing mechanisms. Several blueprints are readily available in this regard (e.g. fund structures, based on CDM experiences, etc). However, this approach requires a NMM setting that has matured to a level which gives private sector a sufficient confidence to actually opt into NMM.

This option is considered to be applicable to all entry windows, with limitations during the early phase of entry window 1.

We hope that these views further contribute to the international dialogue on New Market Mechanisms.

(KfW)