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Executive Secretary  
UNFCCC  
Haus Carstanjen  
D 53153, Bonn, Germany

Geneva, July 16, 2012

Attn.: Mr. Aysar Ahmed Al-Tayeb, Chair, Ad Hoc Working Group on Long-term Cooperative Action

Dear Ms Figueres,

IETA and the WBCSD are jointly writing to you in response to the invitation to Parties and observer organizations for further views on a “framework for various approaches” and a “new market-based mechanism” as referred to in decision 2/CP.17, paragraphs 79-80 and 83-84, including their experiences, positive and negative, with existing approaches and mechanisms, as well as lessons learned.

In the detailed submission below, IETA and the WBCSD put forward its arguments on how a new market mechanism, building on existing market approaches are critical to achieve the levels of GHG reductions needed. This submission is based on IETA and the WBCSD members experience with existing mechanisms and an analysis of possible new market mechanisms.

IETA and the WBCSD are at the disposal of the AWGLCA and its secretariat for any clarification, further elaboration or commentary that may be required. We applaud both the decisions of Conference of the Parties on these matters made at Durban, and the initiative to seek comments from interested and experienced observer organisations. We urge that the work programmes and the workshops referred to in paras 82 and 86 of the Decision 2/CP.17 should make full use of the experience of organisations focussed on markets and market-based mechanisms, and stand ready to participate in the workshops and assist in the programmes as necessary.

Yours sincerely,



**Dirk Forrister**

President and CEO

International Emissions Trading Association



**Peter Bakker**

President

World Business Council for Sustainable Development

## **Market Mechanisms as the Central Pillar of a Climate Policy Framework**

Joint submission to the Ad Hoc Working Group on Long-term Cooperative Action under the  
United Nations Framework Convention on Climate Change

by the

International Emissions Trading Association (IETA)

and the

World Business Council for Sustainable Development (WBCSD)

*IETA and WBCSD thank representatives of the Center for Climate and Energy Solutions, the Center for European Policy Studies, the Environmental Defense Fund, and the Harvard Project on Climate Agreements for participating in a workshop intended to explore the issues addressed in this submission. However, these organizations have neither reviewed nor approved this submission and take no responsibility for the content*

**July 2012**

## **The importance of a market-based approach**

In many jurisdictions, the use of market-based mechanisms to addressing climate change is the preferred policy approach. For example, emissions trading schemes are either in place or emerging in the EU, New Zealand, Australia, California, Quebec and China amongst others, and discussions on how schemes could be linked is already happening. The main aim of utilising a market-based approach for climate mitigation is to give value to carbon emission abatement opportunities that will incentivise global low-carbon investment in order to achieve long-term global emission reduction goals. This must be a **core element** of a new international climate policy architecture or framework that countries can opt-in to and utilise if they wish to increase the cost effectiveness of mitigation. Each country may decide whether it wishes to use market mechanisms or not within the various policy options available for GHG reductions. The use of market mechanisms increases the cost effectiveness of mitigation and enables ambitious mitigation action. This cost efficiency in turn incentivises countries (or sectors of the economy within countries) to increase their emission reduction ambition.

This submission proposes the development of a framework, which includes both crediting and trading mechanisms, which will facilitate the multilateral linkage of various regional, national, sub-national (e.g. sectors within a country) approaches, supported by standardised global measurement, reporting and verification. This will facilitate the eventual development of a global carbon market and should seamlessly transition from the current structures to allow continuity.

## **Key design features of a market-based framework and market blockers**

From a business perspective, a new framework that facilitates the development of market-based instruments must be designed to be attractive to all key actors: developing countries, developed countries, and investors, and should:

- Include a demand for emissions reductions which will be satisfied through trading or crediting the emissions reductions achieved by actions
- Provide supply through access to scaled-up emission abatement opportunities whose use will be triggered by demand. Trading of units can also stimulate demand, while crediting requires demand from other schemes.
- Create demand through an agreed global trajectory of emissions caps with bottom-up approaches on individual country contributions. These caps will create the scarcity needed for trading. When establishing caps, Parties should specify their actions to reduce or limit emissions and the caps induced from those actions.
- Provide confidence to private sector investors through the long-term viability of the scheme. A future climate change agreement should help to provide this long-term certainty.
- Adopt measures to ensure the 'quality' of credits generated through a crediting mechanism in order to safeguard environmental integrity (i.e. ensuring that emissions

reductions are additional), including through transparent and open sharing of information and processes.

- Incentivize Parties to opt for large-scale emission reductions across broad sectors of the economy rather than taking only a project-based approach. If market approaches utilize trading to reduce emissions, there are very few risks, since the performance of emitters will always be remunerated either by internal demand or by exporting the credits, whereas a crediting approach requires risk mitigation measures by government since there is no guarantee that if the emitter makes reductions below the baseline it will be rewarded.
- Facilitate multilateral linkage of regional, national and sub-national approaches, whilst ensuring that clear methodologies are set for monitoring, reporting and verifying (MRV) emissions, allowing emissions reduction efforts to be converted into credits (or allowances) that are internationally fungible.
- Create and/or strengthen market infrastructure that Parties may wish to use such as issuance procedures, registry, auction mechanism, etc.
- Include systems that provide regular feedback and updates on the market's performance for policymakers to track closely.
- Specify a harmonised set of cost-containment measures, including geographical measures (offsets), and temporal measures (banking and borrowing).
- Provide assistance to developing countries for capacity development, including institutions required for efficient market operations, linkage of domestic markets to a global trading or crediting systems, and for other market-related functions.

Recognizing that it is fundamental to the integrity of carbon market mechanisms that they are supplemental to domestic action, a new framework should **avoid** the following 'blockers' to the effective functioning of markets:

- Imposing additional restrictions post-design. For example, provided that the verification of stringent eligibility criteria is part of the international market, including that its use is supplemental to domestic action, imposing floors on the percentage of emissions reductions that must be achieved domestically, instead of through trading - either of allowances or international 'offset' credits, should be avoided.
- Encouraging 'anti-gaming' behaviour whereby countries only set soft targets or receive emission reductions for activities taken in the past. Rather, there should be incentives that encourage countries to establish long-term emission trajectories and therefore make long-term reduction targets.
- Allowing direct trade of AAUSs between countries which might be done for political reasons rather than for economic optimisation of mitigation options, and consequently distorts the discovery of a market price for carbon.

## A potential market-based policy framework

A key element of a new climate policy architecture must be the development of a framework that ensures that key developed and developing countries are actively involved, respecting the principle of "common but differentiated responsibilities and respective capabilities." Some Parties may choose to participate in international emissions trading markets, with targets differentiated according to their state of development, while others may use a new market mechanism or the Clean Development Mechanism. Each Party would choose a path according to their respective responsibilities and capabilities.

Second, this framework must allow **flexibility for nations to use market-based mechanisms on an opt-in basis**, in order to reduce costs, increase efficiency and attract investment. Countries have the option to reduce emissions purely through their own domestic policies or to use market instruments. The choice of whether to 'opt-in' or not will depend on the country's national circumstances, the desire to attract private sector investment and increase financial flows into the Green Climate Fund, and the availability of mitigation options. For some countries, the CDM may be the preferred mitigation tool due to their national circumstances, and they should be allowed to use that mechanism alongside a new market-based mechanism if needed. Any new market mechanisms should build on the experience in the CDM including with data, MRV and standards.

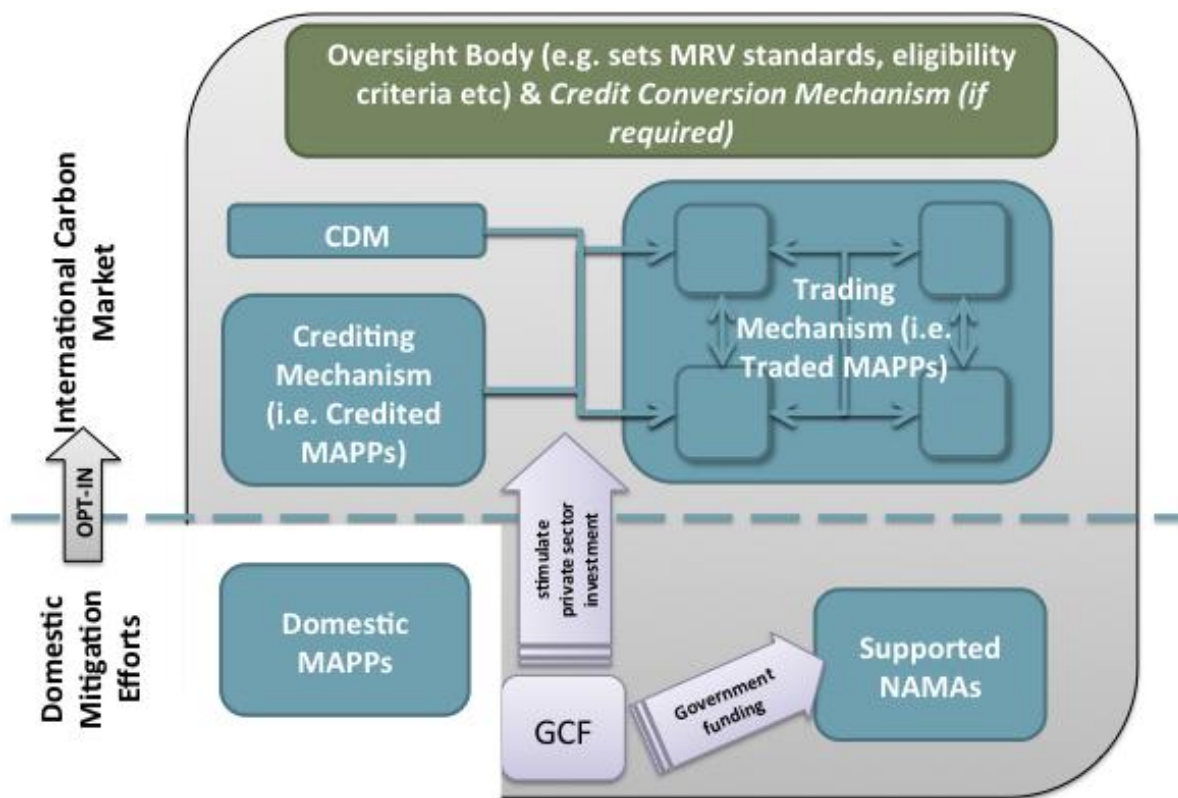
Third, the framework must include market mechanisms that create both **demand and supply**. Hence both a crediting and trading system should be established that takes into consideration the risks of participation in these mechanisms and the cases of non-performance of certain sectors into the scheme.

The framework facilitates the **multilateral linkage** of different regional, national and sub-national mitigation actions, policies and programmes (MAPPs). This would include both developed countries mitigation actions / policies and developing countries plans (i.e. their Nationally Appropriate Mitigation Actions or NAMAs).

If, and when, countries decide to use the global carbon market (either through crediting or through trading), the ideal framework is a **set of schemes based on CO<sub>2</sub> emission abatement units**. In this case, a country does not need a *credit conversion mechanism*, instead it would link smoothly with other schemes. A credit conversion mechanism would allow entities to use international crediting and trading mechanisms even though their respective environmental products are of different denominations. The credit conversion mechanism should remain only as a residual option for countries that opt for different units of measure for their scheme. A **stringent MRV process** would need to be developed to ensure credits (and/or allowances) were fully fungible and safeguard the environmental integrity of the system (e.g. avoid double counting). An example of a how this credit conversion mechanism would work is provided in Annex 1.

This requires **top-down policy instruments** (e.g. defining MRV, standards, eligibility criteria, credit conversion approaches) with an ex-post system of guaranteeing credits are issued fairly and the MRV process is robust. An **oversight body** (e.g. a *Carbon Market Executive Board*) is an option to provide the necessary **governance** of the system and could issue credits when countries decide to opt-in to a global framework. Any such board, while having a critical role to play in providing guidance and recommendations, will need to fit within realistic expectations and real-world governance of nations which will retain much of their authority over capital flows. This could either fall under the UNFCCC, or independent of the UNFCCC (i.e. a Board elected by countries participating in the market ensuring a balance of representation from developed and developing countries). Aside from managing the credit conversion process, issuing credits and allowances for the countries that opt-in to a global framework, and setting standards for MRV, this board (or oversight body) must also be responsible for defining and reviewing eligibility criteria for allowing a country (and / or sectors within country) to use the market instruments (i.e. crediting or trading).

**Diagram 1: Illustrative structure of a market-based framework**



- Use of the **CDM** should be used by projects that fulfil the goals of both mitigation and sustainable development as the CDM originally intended.
- Use of the **Crediting Mechanism** should not be restricted, except to ensure the quality of credits.
- Developing countries (through their NAMAs) are eligible for direct support from the **GCF**. The GCF should also be used to incentivise private sector investment in the market (e.g. though providing insurance).
- Countries not wishing to utilise the market instruments or receive funding under the GCF, can take mitigation actions unilaterally (i.e. **Domestic MAPPs**) and will not be subject to any oversight.
- This is not the Green Climate Fund's (GCF's) only function-the GCF could also be supporting projects/policies/plans which are not bound to market mechanisms

## **Continuity with current market-based approaches**

Any new framework built on a market-based approach to emissions reduction should provide continuity with the present UNFCCC structures (such as Kyoto and the CDM), regionally established trading schemes (such as the EU ETS) and emerging market linkages. The key strength of Kyoto was in its coherent design which provided a framework to create both **demand and supply**. Demand came from the ex-ante allocation of allowances (Assigned Allocation Units).

What happens between now and 2020 is crucial, as there are very few incentives for the private sector to make climate change mitigation and adaptation investment decisions. It is important also to allow space for a reformed CDM in order to build the bridge between current and future market mechanisms to reduce global emissions. If this transition is not well managed then much of the capacities that have been built into the current carbon markets could dissipate and our collective efforts to reduce global emissions will fail. Therefore continuity from the current systems into a new-market based mechanism is critical in order to continue to offer incentives and options for the private sector to invest in low-carbon technologies.

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## **ANNEX 1: Essential considerations for a Credit Conversion Mechanism**

IETA and WBCSD express a strong preference for an international climate policy framework that harmonizes emissions trading systems at the outset. This would encourage business participation in global carbon mitigation efforts by providing simple and efficient market engagement. The fungibility of carbon units in a global system is important for reducing overall compliance costs, which can in turn encourage greater ambition in reducing emissions.

But for those Parties unable to adopt harmonized allowance trading programs, we believe it is wise to consider what would be required for a system to harmonize programs after the fact (or “*ex post*”) in a more decentralized, policy architecture. This *ex post* harmonization system, which IETA has named a “*Credit Conversion Mechanism*,” would enable interested Parties (or their regulated business entities) to convert different carbon-related commodities into common tradable units for use in international compliance markets.

### **Purpose**

The purpose of a Credit Conversion Mechanism would be to facilitate the transfer of different emissions reduction units across a broader range of national compliance systems. This could improve the overall cost effectiveness of the global response to climate change and embolden Parties to strive for greater ambition.

### **Certification body**

A credit conversion mechanism could benefit from a body to oversee the functioning of conversions and transfers. This body could be organized within the UNFCCC framework, alongside other institutions such as the CDM Executive Board. The functions of a certifying body could include –

- registering different programs applying to be included in the conversion mechanism;
- evaluating and determining conversion calculations; and
- maintaining a registry of conversions.

This body would require technical capacity, featuring experts able to make complex decisions regarding conversion rates in a number of fields (energy, agriculture and land-use, construction etc.). A successful mechanism would be able to evaluate credits generated from a number of different countries, sectors, and project types. Therefore, a high level of knowledge in a certification body is essential to derive correct conversion factors from each program. Also, independence from national governments would be helpful in reducing the possibility of decision-making being made based on national interests rather than objective calculations. At the same time this may be counterbalanced by a desire from nations to have proper oversight of decisions made on conversions and determining eligibility.



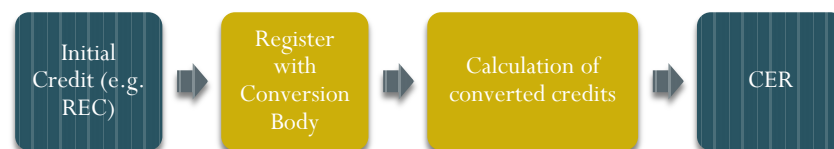
## The Process

For a credit to be converted under an international certification body, it must be underpinned with a robust process and, sound monitoring, reporting and verification standards to maintain environmental integrity. But it must also be simple and straightforward, so as not to discourage its use.

The following is one model for organizing a conversion agreement between a program and the crediting transfer body. Governments (or companies in their programs) would be free to apply to have their credits converted from domestic instruments into common international units. Elements which would need to be evaluated by a certification body include:

- The program's baseline determination, ensuring that it represents an accepted view of the BAU scenario;
- Default emissions factors used to convert energy-based credits into emissions reductions (e.g. energy efficiency credit converted to tCO<sub>2</sub>e);
- The verification process used by the government to ensure that credits are real, permanent and additional.
- A process to ensure that crediting has not been awarded in multiple programs – or factors to deal with reductions benefitting from support from multiple programs.

Once a decision has been made to approve a program to convert credits, the mechanism will allow holders of credits to transfer to CERs, or another common emissions reduction credit, and retire the previous credit. This is illustrated below:



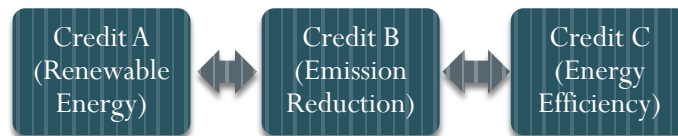
The rigidity of 'exchange rates' between different credits is an important consideration for environmental integrity. For example, the default emissions factor for a particular grid could be a dynamic number, and this input into a conversion calculation would then need to be updated along a feasible timeframe to take into account, for example, growing use of renewables in the energy mix. Therefore, the conversion body overseeing transfers would require reporting of the necessary inputs, with potential verification by a third party, to update the calculation of registered credits.

## Enabling credit transfers

A Credit Conversion Mechanism could enhance the ability of Parties to access international markets where systems are denominated in different crediting types. The Mechanism would convert various types of credits into internationally recognized instruments. As depicted in the chart below, the mechanism could work in a variety of ways. Here are two simple examples:

- First, it could allow a credit from a renewable energy system (Credit A) and a credit from an energy efficiency system (Credit C) to be converted into an internationally fungible emissions reduction credit (Credit B).
- Alternatively, an instrument in a renewable energy market (Credit A) could be converted to an emissions reduction (Credit B), which could then be converted at the owner's request to a credit denominated for use in an energy efficiency system (Credit C).

Either model could enhance fungibility, but the first approach is likely to be more efficient.



## Conclusion

The operation of a Credit Conversion Mechanism raises a significant number of technical and political issues. We continue to believe that harmonization at the front end of the program is preferable to conversion of credits at a later stage. As described in the main body of this submission, if many Parties harmonized their systems in a common allowance trading market, it could minimize the number of disparate systems in need of a Credit Conversion Mechanism for accessing international markets.

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