



VIEWS ON NEW MARKET-BASED MECHANISM

SUBMISSION TO SBSTA

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INTRODUCTION

WWF welcomes the opportunity to present its views on a new market-based mechanism referred in paragraphs 52 of Decision 1/CP.18.

WWF strongly believes that any discussion on future mechanisms (approaches) must take into account the experiences and lessons from the existing mechanisms, especially those ones related to the Clean Development Mechanism (CDM).

Moreover, this whole discussion on “various approaches” has to be done in the context of the global trend of increasing GHG emissions, which would lead us with the present pathways to a world of 4-6 °C warming compared to pre-industrial temperatures.

1. CRITICISMS ON CDM

Since its inception and led by practical observations on the ground, CDM has been under constant criticisms. There have been some success but there have been even more problems in CDM. Any consideration of “new market-based mechanism” (NMM) must be based on lessons learned from those observations and critical analyses on CDM. The list of items below includes some primary concerns. The list is by no means exhaustive but at least these items have to be kept in mind when Parties consider a possible establishment of new market based mechanism.

- **Non-additional projects and credits:** there have been many non-additional projects. In the worst case, the impact is estimated to be 3.6 Gt-CO₂eq cumulatively up to 2020¹. Given the offsetting nature of CDM, this has contributed to a global increase of emissions which may not have happened in the absence of CDM.
- **Negative impacts on/lack of benefits of sustainable development (SD):** there have been projects with negative impacts on or lack of benefits of SD in the host countries², notably some hydropower projects.

¹ Randall Spalding-Fecher et al. (2013) *Assessing the Impact of the Clean Development Mechanism*. Report commissioned by the High-Level Panel on the CDM Policy Dialogue.

² Some studies conclude that there were SD benefits from existing CDM projects. However, such studies typically depend on what is written in Project Design Documents, which do not necessarily represent what happened in the reality. The very lack of systematic monitoring of SD benefits makes it impossible to make definitive conclusions.

- **Human rights violation:** there have been a few cases where serious accusations were made by NGOs in relation to human rights violation such as Aguan biogas project in Honduras and Barro Blanco Hydroelectric Power Plant Project in Panama.
- **Unequal regional distribution:** CDM projects were distributed very unequally among host countries. In particular, Africa was lacking a ‘fair share’ and about 70% of all registered projects centred in India and China.
- **Lack of technology transfer:** CDM has not caused technology transfer at necessary scale. So far, we have no evidence that any new technology used in CDM projects has been expanding beyond CDM in host country because of CDM.
- **Distortion of the market due to the dominance by HFCs and N₂O:** a large portion of CERs came from HFCs and N₂O projects, which have little sustainable development benefits. While initial HFC credits were said to be traded around 3 USD per CER, IPCC/TEAP Special Report on Safeguarding the Ozone Layer and the Global Climate System indicates the reduction cost of HFC-23 is actually 0.2 USD per t-CO₂eq. This presents one case where the “market” did not deliver efficiency.
- **Perverse incentives:** there are perverse incentives for parties to refrain from implementing strong climate policies to keep CDM options open. In 2009, a few wind projects in China were initially rejected by the Executive Board because it was suspected that feed-in-tariff were lowered compared to historic levels so that those projects would be registered as CDM. This issue has been in part dealt with so-called E+/E- policy rules but it remains to be an issue.
- **Double counting:** Parties need to make sure that emission reductions in projects can be only counted once. However, a number of CDM projects are used by Annex I Parties to achieve their emission reduction targets while emission reductions from those projects are also counted in the context of host countries’ claims of emission reduction.

2. WHY IS IT STILL WORTH CONSIDERING NMM?

Given the above-mentioned criticisms on the existing mechanism, WWF approaches the concept of NMM with great caution. In addition, expected demand for carbon credits in the future is quite low and oversupply is already anticipated due to the low ambition by developed country parties. There is, unfortunately, no sign of increasing ambition. Then, why is it still worth considering NMM? Below are three *possible* reasons.

First, there is expectation that NMM could, if designed properly, overcome some of the problems related to today’s CDM. It should be noted there could also be *new* risks related to NMM. This expectation translates into one important condition for WWF: if NMM repeats the failures of the existing project-based offset nature of CDM, WWF will oppose to it.

Second, NMM is expected to tap emission reduction potentials in developing countries at a larger scale than CDM does. Except for HFC/N₂O projects (which we do

not think have a place in CDM anymore), average emission reductions from individual CDM projects have been typically less than one million tonnes of CO₂ equivalent per year. Although the reductions can be meaningful in aggregate, the scale of required emission reduction is far more than that. Primary proposals for NMM such as sectoral crediting and sectoral trading for a large emitting sector (e.g. power, steel, cement, etc) of one country or region are meant to have larger coverage of emissions than project-based CDM. Setting aside the issue of offset nature, this possibility of tapping huge emission reduction potentials is one important reason.

Third, NMM is also expected to bring about larger private financial flows and investment in both direct and indirect (leveraging) manners. The 2007 UNFCCC secretariat's study estimated that the necessary scale of financial flows and investment as of 2030 would be 210 billion USD per year including both private and public finance. The current financial CDM flow is very modest compared to this size. For example, the record high traded value of Kyoto credits (not investment and financial flows *per se*) in 2008 was around 34 billion USD, according to World Bank's statistics. WWF has been stressing the importance of public finance but it is also important to have a scheme to encourage private finance for low-carbon and zero-carbon solutions.

Whether NMM can meet these expectations is unclear at this point. WWF will carefully follow the discussion in negotiations and will evaluate whether NMM would become a valuable scheme or just another loophole for the already huge gap for the necessary emission reduction. In the latter case, WWF does not support the establishment of the scheme at all. We cannot underline the importance of these conditions enough. Parties have to bear in mind that the current low ambition gives little (if any) justification to establishing NMM or any other market-based approaches. From this perspective, it is crucial that the discussion put emphasis on the general principles in the next section.

3. PRINCIPLES

There are five principles that WWF believes are important when Parties consider any possible market-based mechanisms. Below are explanations for those principles and some comments on the existing decisions adopted in Cancun, Durban and Doha.

3-1. Securing net atmospheric benefits

Any new market-based mechanism must go beyond offsetting. NMM must be generating net additional emissions reductions that would not occur in the absence of NMM. There are four potential and mutually inclusive procedures to go beyond offsetting. The first is to adopt "no lose" target in baseline/reference level setting against which emission reduction units are issued. The second is to adopt environmentally sound discounting rates such as a 1: 3 ratio – 1 ton accounted for in investment country and three tons effectively reduced in host nation - for issuing/counting emission reduction units. The third is to encourage/require retirement of (at least portion of) credits by the acquiring parties. The fourth is to place limitation on the length of period when credits can be generated. There are both advantages and disadvantages for each of these approaches but at the heart is that the atmosphere cannot afford a pure offsetting scheme anymore (see Section 5-1). If NMM were to become a pure offsetting scheme, then there would be no reason to support its establishment from environmental perspective.

In the Cancun Agreements (1/CP.16), "ensuring a net decrease and/or avoidance of global greenhouse gas emissions" is listed as one item to be considered when Parties consider the establishment of NMM. This could be one basis for exploring the above-mentioned approaches. In the Durban Agreement on the Outcome of the work

of the AWG-LCA, this is again stated: COP “[e]mphasizes that various approaches must meet standards that achieve a net decrease and/or avoidance of greenhouse gas emissions.” It was also repeated in the Doha decision. However, in case of Durban and Doha, the word “global” is missing (before “greenhouse gas emissions”). The omission might give some room for interpreting this in a different way (e.g. “net” within the activity’s boundary) but “net” reduction must be secured at a global scale.

3-2. Avoiding double counting

Double counting must be avoided. Not only for new mechanisms also for the existing CDM. There are two types of “what” should not be counted twice. Neither *emission reduction* nor *financial flows* should be counted twice.

Emission reduction in one place must not be counted twice as emission reduction in another place. This problem could happen, for example, between NMM and a host country NAMA. This could also happen between NMM and CDM. If emission reductions get counted twice, this factually decreases the achieved amount of emission reduction and thus contributes to widening the already big emission gap. Hence, there must be upfront agreements between partners from the GHG-capped and non-capped world on any project how eventual carbon credits are shared and who receives what.

Similarly, one financial flow should not be given two different meanings, e.g., offsetting and financial assistance. The financial flow related to the purchase of credits by one country cannot be counted as a financial assistance to the host country. Money for purchasing offset credits is not financial assistance. If the financial flow for offset gets counted as financial assistance, it could reduce the total amount of financial support from developed countries to developing countries and thus reduce the emission reduction that could have occurred otherwise.

In addition, based on the recent analysis by the Climate Policy Initiative (CPI), as part of overall climate finance of about USD 364 billion in 2011, private sector investments into mitigation technologies, mainly renewable energies and independent from CDM were already in the range of USD 217 – 243 billion. Of that, about USD 85 billion were invested in developing countries³. We urge that private sector financial flows for clean technologies – and we strongly support that this amount is growing substantially – shall not count against the objective of generating USD 100 billion by 2020 per year for overall climate finance by the Annex I countries.

In both Cancun and Durban agreements, the necessity of avoiding double counting is stated but the clear meaning is not defined. In the upcoming discussion, the avoidance of double counting of both emission reduction and financial assistance should be clearly and pro-actively defined.

3-3. Ensuring sustainable development benefits

Any mechanism has to contribute to sustainable development of the countries concerned. Under the current CDM, the Designated National Authority (DNA) is the gatekeeper of ensuring sustainable development but the experiences in CDM found that not all DNAs have sufficient capacity or incentives to assess various projects' contribution to sustainable development at least in their early stages. Such lessons should be taken into consideration in considering NMM and an improved way of assessing sustainable development benefits have to be developed.

Contribution to sustainable development is only vaguely mentioned in the chapeau in the Cancun Agreements and it was not included in the “standards” in the Durban Agreements. This has to be changed and it should be an essential condition for NMM.

³ Barbara Buchner *et al.* (2012) *Global Landscape of Climate Finance 2012*. Climate Policy Initiative.

It would be very difficult to set specific standards for sustainable development at international level but it should be possible to make it mandatory for parties to set their own criteria of sustainable development and to assess and monitor contribution of activities under the NMM.

3-4. Ensuring complementarity

Use of mechanisms must not discourage parties to implement domestic climate actions. This issue is especially relevant for NMM because the underlying assumption is that the mechanism would provide larger supply of credits than CDM did. In this respect, the use of credits from a NMM has to be supplemental to domestic mitigation actions. This principle is not intended to discourage developed country Parties to support developing country Party to pursue ambitious emission reductions. Rather, it is to ensure that developed country Party fulfil its responsibility as well as to avoid 'lock in' of carbon intensive infrastructure in their countries.

The complementarity principle is mentioned in Cancun, Durban and Doha agreements. However, the definition of complementarity remains vague. Ideally, there should be quantified limit for the use of emission reduction units from any market-based mechanisms so that parties can place the majority of efforts and emphasis on domestic actions.

3-5. Avoiding deprivation of low-hanging fruits

Mechanisms should not lead to taking away low-cost abatement opportunities from developing countries for the sake of emission reduction targets of developed countries. The mechanism has to be designed so that this could be avoided and it helps developing countries to tap relatively high-cost abatement opportunities. The implementation of this principle is extremely difficult. One possible way to do so is to let the host country to define a list of technologies that should be ineligible under the mechanism ("negative list" for low-hanging fruit technologies).

This principle is not found in either of the Cancun Agreements, the Durban Agreements and the Doha agreements but it has to be included in the upcoming negotiation.

4. COMMENTARIES ON SPECIFIC PROPOSALS

There are three specific proposals for new market-based mechanisms, namely, sectoral crediting, sectoral trading and NAMA crediting. All of them are meant to widen or broaden the scope of existing CDM. WWF does not have preference for any of these proposals at this point until the above-mentioned principles are secured. However, for the sake of discussion, for each of the proposals on the table, WWF provide some comments below.

4-1. Sectoral crediting

- **Ambitious thresholds:** the currently proposed sectoral crediting assumes the use of so-called "no-lose" target, i.e., the threshold against which emission reduction units get issued has to be well below BAU emissions. Theoretically, this is a good way forward to go beyond offsetting as well as to mitigate the risk of non-additional credits. However, one major concern related to this scheme is if the threshold can be appropriately set or not. Host countries structurally have incentives to inflate BAU emissions and thus the thresholds. Although the detailed design of the scheme has to be

country-specific, internationally agreed standards have to give clear guidance on this point. This means practically, that sectoral baselines for each sectoral credit scheme have to be agreed by independent reviewers and experts. The UNFCCC secretariat shall be facilitating such a process.

- **Robust data:** emission reductions must be measured, reported and verified in a robust manner. For this purpose, collecting robust data for emissions and their underlying activities is crucial. Not every country has such capacity. Not every sector in a capable country would have such capacity, either. Therefore, as is the case in Kyoto mechanisms, the availability of robust MRV system in the concerned sector must be one crucial condition for the implementation of the mechanism.
- **Definition of “sector” and its coverage of emission sources:** although a sectoral crediting system is generally understood to cover wider activities than a “project” activity in CDM, the definition of sectors has not been clarified. It is possible to define the sector in terms of economic coverage such as “steel” sector or “transport” sector but it is also possible to define the sector in terms of geographical coverage such as metropolitan areas, provinces, etc. Depending on the definition, it is also important to set standards for emissions and activities of individual entities to be covered within the sector so that any major portion of emissions does not get missed. In any case, accounting for ‘sectors’ emissions and/or reductions shall happen on the basis of direct GHG emissions of this sector to the atmosphere following IPCC accounting methodology. Addressing indirect emissions (scope 2 from industry for example) or embedded emissions (in traded products) need a different approach.

4-2. Sectoral trading

Sectoral trading shares the same concerns as sectoral crediting mentioned above.

- **Overselling:** In case of sectoral trading, it is assumed that allowances are issued *ex-ante*, meaning participating actors within the sector will receive allowances at the beginning of activities under the scheme. Due to this nature, there is a risk of overselling of allowances to outside of the host country. This has to be prevented primarily through a design of the scheme itself in the concerned host country, such as a quantitative limit on sales at any time until the end of the commitment period, but this can happen as an unintended consequence of collective actions taken by private actors and remedies have to be designed in advance.

4-3. NAMA crediting

- **Definition of NAMAs:** The definition of NAMAs is not clearly set in the current negotiations. Any scheme to issue credits for emission reduction by NAMAs has to come with a clear definition of NAMAs. This is especially important with respect of avoiding double counting of emission reductions

because emission reductions in NAMAs would be mainly counted towards achieving developing countries' voluntary pledges. If reduction units from "NAMA crediting" are counted in developed countries again, it would decrease the overall emission reduction at a global scale. To avoid such situation, NAMA activities and its contribution have to be differentiated if NAMA crediting is developed. In other words, unless such definition and differentiation is possible, NAMA crediting is not a good candidate of NMM.

- **Eligibility criteria:** Not all NAMA activities will be suitable for crediting. For instance, it is essential to have emission reduction measures, reported and verified if tradable units are issued for the GHG reductions. For some emission reductions activities, this might not be possible or desirable. Eligibility criteria for which activities can be applicable to crediting must be clearly defined.

5. ISSUES OUTSIDE THE MECHANISM

There are issues outside the mechanism that affect the value of the mechanism significantly. Although these issues are beyond the scope of this submission, they have to be clearly kept in mind nonetheless.

5-1. Gigaton Gap

When considering a possible market-based mechanism, we need to take into account the huge emission gap between what is necessary and what has been pledged by parties so far. The recent UNEP report indicates that there will be a 8-13 CO₂e gigaton gap in 2020 for achieving the 2 °C target. Some portion of this gap comes directly from issues related to market-based mechanisms in general. For example, the use of offsets is assumed to contribute to the gap in the order of 1.5 Gt CO₂e in the study.

Apart from the mechanism-related loopholes, developed country parties must close the gap essentially through substantially raising their own ambition levels. Developed country parties on an aggregate base are far from committing to an up to 40% GHG emissions reduction target by 2020 below 1990 levels as was deemed necessary by the IPCC AR4 in order to stay below 2 °C global warming. The present dangerously low level of ambition by developed countries gives little justification to relying on NMM. It will give only low prices to credits, which do not facilitate much reduction action. The overall ambition level factually decides whether it is meaningful to have the mechanism at all.

5-2. A system to track various types of emission reduction activities and reduction

As stated, avoiding double counting of emission reductions and financial flows is an integral principle. To achieve this purpose, Parties need institutional arrangements to follow emission reduction activities and reductions in various forms. This cannot be done in the realm of NMM only as it has to cover and keep consistence with emission reduction caused in activities not related to market mechanisms. Such system has to cover a wide variety of emission reduction activities, ranging from NAMAs to NMM to possible non-market-based mechanisms or approaches. The "registry" under development in the current negotiations could provide a good basis for this purpose but it is essential for the system to have ability to differentiate credited activities from others.