

# CARBON MARKET FORUM



*Thinking ahead for Europe*

## CEPS CMF Submission on Review Modalities and Procedures for the CDM

This report was prepared as a submission to the Subsidiary Body for Implementation. It draws on discussions that took place among the members of the CEPS Carbon Market Forum (CMF).

The CMF provides a neutral space where policy-makers and regulators are able to meet carbon market participants and other stakeholders to discuss carbon market regulation and general policy issues. The contents of this report reflect the general tone and direction of discussions on specific topics within the CMF, but its findings do not necessarily represent a full common position agreed by all the participants in the CMF, nor do they necessarily represent the views of the institutions to which the participants belong.

1. The review of the Clean Development Mechanism (CDM) Modalities and Procedures (M&P) is enshrined in the Marrakech Accords (Decision 3/CMP.1, para 4). It was also addressed in the CMP Guidance to the CDM EB document from COP 18 in Doha.
2. Discussions on other future aspects of the CDM also took place in the AWG-KP, where a number of changes to the CDM were proposed. Most of them were discarded altogether, or were sent for consideration to other negotiating bodies.
3. The CDM Executive Board (EB) has also initiated the High Level Panel on CDM Policy Review that put out a set of recommendations, which were widely disseminated.
4. The CDM has been through a long and complex growing process since it was approved as part of the Kyoto Protocol (KP). It was designed within the framework of the UNFCCC, and the Kyoto Protocol, and the political and economic realities of that time.
5. It has proven to be more successful than many may have expected. Among its key successes one should acknowledge that the CDM has:
  - a. Successfully harnessed the entrepreneurial power of markets and the private sector to meet sustainable development goals and environmental targets;
  - b. Demonstrated how culture can be changed around the world by putting a value on GHG reduction actions;
  - c. Mobilised more capital for GHG mitigation actions, especially from the private sector, than many established international financial institutions;
  - d. Provided lessons learned and established standards that were useful for its own improvement, as well as for the design of new market mechanisms around the world;
  - e. Established a link between different domestic markets;
  - f. Served as a splendid example of a public-private partnership and
  - g. Built capacity to address climate change around the world.
6. Through improvements over the last ten years, sometimes unnecessarily slow and painful, the CDM has now reached a point where it is beginning to function in a reasonably efficient way, under the guidance of a regulatory body, the CDM EB, which has also matured.
7. The questions that need to be answered are:
  - a. Why do we need a CDM? Is there a need for an instrument such as the CDM in the future and what demand can it fill? Why do we want to reform it, and not scrap it?
  - b. What are the factors that will influence the changes that are needed?
  - c. What are the changes that the CDM needs to undergo to adapt to the future – internally, as well as in relation to the external environment?

8. The review of the M&P is not taking place in a vacuum, but in the context of important negotiations for a post-2020 climate change agreement. That reality needs to be acknowledged, and taken into account during this debate.
9. Any changes in the CDM will need to comply with provisions in the Kyoto Protocol. Until 2020 the CDM will need to provide the services that the KP envisages for it.
10. There is a second aspect to the future of the CDM that will also need to be addressed, which is the place of the CDM in the new international architecture. That role will be highly dependent of the content of the international agreement to be reached in 2015. Until such time as a new climate change agreement enters into force, or a timeline in the new agreement that indicates the role of the CDM in the new architecture, the CDM will have little, or no role to play, outside the KP.
11. A discussion on the role of the CDM in the new climate change agreement will need to make significant assumptions about the new architecture, including the role of markets in general, the outcome of negotiations on the New Market Mechanisms (NMM) and the Framework for Various Approaches (FVA), compliance provisions, accounting, etc. All these discussions will be finalized and brought together under the umbrella of the Ad Hoc Working Group on the Durban Platform for Enhanced Action (ADP), which is why CEPS recommends that any changes to the CDM that are related to the role of the CDM post-2020, or its role as part of the new climate change agreement, should be discussed under the ADP.
12. Consequently, the body of this paper will provide proposals for changes that address the CDM in its current role and will only discuss the CDM post-2020, without providing concrete recommendations.
13. One important issue raised by many stakeholders is that of the demand for CDM products: CERs. Lack of demand for CERs, as is raised below, is one of the critical issues facing the CDM right now. It is difficult to maintain a viable instrument, regulatory or otherwise, if there is no demand for its products.
14. However, a clear distinction must be made between the review of the M&P, and a discussion of what needs to be done in order to ensure demand. This paper will not contain recommendations on how to increase demand, as we feel that it is not within the scope of this review. It will discuss the possible roles that the CDM could play under its current KP governance, which indirectly may provide suggestions of how to produce demand for the CDM.
15. A discussion in demand in the review of the CDM M&P would lead to justification of gridlock in the development of NMM due to the absence of new demand. That is not desirable in our view.

### **A changed environment**

16. The political and regulatory premises upon which the CDM was designed and built have changed dramatically. As such its orientation, role and functions, must be revisited. The new developments that must be taken into account include:
  - a. The CDM was conceived as an offset provider. That approach is not acceptable anymore; we need net reductions.

- b. The sources of demand, which have been the EU and Japan, have decided to severely limit, through regulatory intervention, the demand for CERSs.
- c. The economic situation over the last few years has led to lower emissions, and consequently to a long position for emission permits in the carbon market for the foreseeable future.
- d. The CDM was built in a framework of Annex 1 and non-Annex 1 countries. That framework is changing in the post-Cancun world.
- e. With deeper cuts in GHG emissions that the science demands, new mechanisms are needed. Some of them will be developed at the UN level, while others will emerge from national initiatives. The CDM will lose its 'monopoly' and will need to compete in the marketplace of ideas based on efficiency and efficacy with other mechanisms.
- f. The orderly world of the KP is being replaced by a fragmented and complex world of market initiatives. This world will require standards to ensure environmental integrity.
- g. Significant financial resources will be deployed in the future to meet adaptation and mitigation needs. This will require imaginative ways to leverage private sector finance, which will also need access to processes and platforms to identify environmentally credible GHG reduction opportunities.

### **Why do we need the CDM?**

- 17. The main roles that the CDM has played so far have been:
  - a. Direct finance towards mitigation projects in developing countries.
  - b. Help control cost of compliance in developed countries.
  - c. Accomplish an indirect linking between markets that existed, in different formats, in developed countries.
- 18. For the period leading to 2015, and beyond, the main demand for CERs would have to come from those Parties that are part of the Kyoto Protocol, that need emission reductions, and wish to use them for sovereign or domestic compliance. In addition, the impact of the KP amendments from Doha would also have to be factored in.
- 19. The EU, as the main market, is unlikely to provide much demand for CERs through the EU ETS. This is due to the current market situation as well as provisions in the EU ETS that limit the possible influx of international credits (see EU Carbon Market Report "The state of the European Carbon Market in 2012", European Commission). Data from the EU Environmental Agency seem to indicate that the EU has already made great strides to reach its 2020 target of -20% compared to the 1990 baseline, or it is close to doing so. This is due, in large part, not only to efforts to reduce GHGs, but also to the deep and prolonged economic recession. However, while the recession was deep, economic forecast is always a difficult art, and unexpected growth can always produce increases in GHG emissions.
- 20. Australia will also produce some demand for CERs, but not in numbers significant enough to make a difference. Climate Connect estimates that the Australian cap-and-trade system will create additional demand for around 19 million units per year from 2015 onwards.

21. Finally, there is a large CER surplus currently in the market, that cannot be absorbed, and that will be able to meet foreseeable increases in demand.
22. However, CDM will continue to be a viable instrument. It will be very desirable to maintain it as one of the options available to Parties and private sector, for a number of reasons:
  - a. There will continue to be demand for certain, very specific, types of new CDM projects.
  - b. The projects currently registered will continue to produce and try to find a market for their products.
  - c. Certain host countries, due to capacity level, and the structure of the economy, even in the new climate change architecture, will only have the ability to use the CDM in their jurisdiction.
  - d. The CDM could be used as a supply platform to offer environmentally credible GHG reductions that could be used by a Fund looking to deploy funds for mitigation, such as the Green Climate Fund (GCF). This makes eminent sense and is a credible scenario that must be seriously examined. The specifications for the products (type of CERs) accepted can be developed by the Fund. There can be no expectation of a monopoly for the CDM as supplier for the GCF.
  - e. The CDM provides real experience on the use of crediting mechanisms, and is now expanding that through the use of the Program of Activities and Standardized Baselines. As such, for all its criticisms, the CDM has developed a valuable knowledge base in operational and methodological terms and is a de facto standard against which most new crediting schemes are measured.
  - f. The CDM infrastructure is also very valuable for the development and operation of both New Market Mechanisms under UNFCCC as well as the integration of domestic ones under the UNFCCC umbrella.
23. Given the provisions in the EU ETS, which allows the continued importation of CERs from new projects in LDCs, as well in the parameters of various national purchasing programs, which continue to encourage purchase of CERs from LDCs, there will continue to be pockets of demand for some types of CERS designated by technology and geographical origin. This would indicate that there will continue to exist, even if reduced, a demand for the services of CDM.
24. The transition to the new climate change architecture seems to indicate that linking trading systems will be the focus with a limited role for CERs to address reductions.
25. However, the CDM experience will continue to play a big role in the discussions that we have in design of the new mechanism which originate at the international level, as well as in the domestic mechanism that are emerging worldwide. It has been, and continues to be the only global mechanisms and is seen as a baseline, and as a standard.

### **Proposed changes to the CDM Modalities and Procedures**

26. The “new climate change order” is creating multiple GHG markets. Since the start of the KP mechanisms and the EU ETS, market players have been chasing business opportunities around the world.

27. This competition took place in the context of a monopoly of the KP mechanisms outside the EU ETS, where the CDM was the dominant player, with little competition.
28. However, the CDM is now being challenged, and what is now emerging is a “marketplace of ideas”. This new marketplace is being superimposed on the marketplace for business opportunities. Market players will be competing on the economic terms that they offer, but also potentially, on what mechanisms they can, and will use, for a project to be monetized. Some will offer to monetize the project through CDM, others through BOCM, VCS or California offsets, and maybe other forms in the future.
29. This competition will take place in a number of areas, including **monetary value** and **risk**. Both these dimensions are highly dependent of the perceived **environmental performance** of a project.
30. All other things being equal, monetary value will be driven by supply/demand fundamentals, its efficiency (cost of doing business), but also by access to GHG markets, in the form of cap and trade (EU ETS, Australia, South Korea, etc.), or other type of demand generated around the world. The better the access to markets, the higher the value that can be expected from the product.
31. In turn, access to markets will be granted by regulators, such as in the case of the EU ETS, based on environmental integrity and sustainability.
32. Risk will be primarily regulatory (governance, predictability), as well as reputational. Investors are concerned about reputational risks, which have been observed especially when related to human rights.
33. The proposals below cover a number of areas where improvements can be made to the CDM in areas that would impact monetary value and risk.
  - Extract increased efficiency from the CDM in its current role, and under the KP architecture
  - Enhance its environmental integrity and contribution to sustainable development
  - Better governance, especially transparency and predictability

### *Sustainability/Environmental Integrity/Reputation*

34. The CDM’s reputation has suffered from criticisms on a number of fronts, in many cases based on ideology, rather than on-the-ground realities. The most important ones have been related to the additionality of its projects, the impact on sustainability and the lack of attention to co-benefits.
35. **Sustainable Development.** Since the 1992 United Nations Conference on Environment and Development (UNCED) in Rio de Janeiro, defining sustainable development (SD) priorities has been the prerogative of a sovereign country.
36. Since promoting SD is one of the two objectives of the CDM, there are strong views that CDM has not really promoted SD, and that this should be accomplished through the introduction of an assessment of the SD impact of projects.

37. Mandating greater transparency is needed and should be welcomed and implemented. On the other hand, defining what should be reported and how it is to be measured can easily cross the line into imposing definitions of SD on host countries. This could set back the sustainability agenda by creating the perception, but also maybe the reality, that SD is becoming a way to impose foreign standards on host countries. As such it is essential that the use of the sustainable development tool remains voluntary, and not be presented as an integral part of the project assessment. In line with national standards, it should not be monitored and verified at the international level, but at the national level, as one of the components for the host country to grant approval and a continuous license to operate for the project.
38. Additional obligations will impose additional costs as well as interfere in the domestic priorities of a country. However, the CDM is an internationally recognized, UN approved mechanisms and as such it does carry a higher burden of proof. *What could be useful is to explore the possibility of ensuring that CDM projects, not dissimilar to the Global Compact arrangement of member companies, also sign to a "CDM Global Compact"*. Therefore, the modalities and procedures shall clarify that the implementation of project activities under the CDM shall not be in violation with articles of the Universal Declaration of Human Rights. It is only natural, we feel, that any units that are used to meet compliance obligations with a UN treaty, should be able to state that they meet the conditions of other relevant UN treaties.
39. We believe that this would address the issue of sustainability for CDM projects, as well as the need to present sustainable development co-benefits, which is proven to be controversial.
40. **Host Country Approval.** Host countries should, and we expect that they are already doing so, monitor the implementation of projects in their countries. Any project implemented also has to comply with many national laws and regulations. When they grant a Letter of Approval (LoA), Host Countries will consider all these elements, including whether the project meets their SD priorities.
41. Projects operate over long periods of time – 10 or 21 years, depending on the project. Conditions either change in a project, or new aspects may come to light subsequently. Host countries should clearly have the option to withdraw the LoA for any projects that do not observe national legal obligations and SD objectives.
42. At the same time it must be recognised that the introduction of such a provision will introduce a high degree of uncertainty. Such an option should be considered, but it must be pointed out that this will represent not a minor change, but a significant departure, from what was one of the CDM's strengths: international regulation of the CDM cycle. Unless safeguards are introduced, this may simply make the CDM, or any future project mechanism, a difficult proposition.
43. It must be expected that any projects that break domestic laws will be stopped from operating, and as such will, de facto, have their LoA withdrawn.
44. If a Host Country wishes to continue to allow the project to operate, *but wishes to withdraw its LoA, then we must ensure that this is done in a transparent way. This should be done through a process that files evidence to the CDM EB, or its yet-to-created Appeal Body.* Allowing an issued LoA to be withdrawn in what may appear as an

unpredictable and capricious manner, will also reflect on the CDM as a UN mechanism, and the UN as regulator.

45. **Additionality** has always been a hard criticism of the CDM. It is fundamental to a crediting process as it defines what can be credited. Through its counterfactual nature, it can never be a totally objective process. Separating additionality from baseline determination, and creating its own processes, has shown a large uncertainty on the part of the regulator, and a desire for perfection. Uncertainty should be accepted, but mitigated, through the use of standardised approaches. While this will not eliminate criticism, it will provide more transparency and consistency on how additionality is assessed. Even if the market is currently over supplied, and there will be growing limitations on the use of CDM, there will need for large quantities of reductions, and this approach will ensure that we produce real reductions, within known and accepted material boundaries of uncertainty.
46. Changing the complex approach to additionality currently used, is not an easy proposition. However, we must also accept that the CDM is not the only experience anymore. Other processes have emerged, and have been used around the world for determining additionality, such as the VCS. *It is time, under the process of review of the CDM M&P, to examine those processes, see what had been learned from them and what can be adapted.* Many have learned from CDM, but the CDM can also learn from others.
47. **Length of the crediting period.** The crediting periods have been fixed at 10 years, or 3 times 7 year. No changes to methodologies can take place within a trading period. This is an issue that was raised at the last COP and referred for examination to this process. It is clearly cannot be applied retroactively to projects that have already been registered. *However, for new projects, one option could be that the crediting period is not standardized, but set on a project-by-project basis, based on the characteristics of the project submitted.*

### **Increased Efficiency/Efficacy**

48. "Reform of the CDM" has been a long and arduous process started in Buenos Aires at COP 10 in December 2004. Unfortunately, what is meant by reform can vary substantially. While some include some of the issues referred to in the preceding section, many others understand it as increasing the efficiency and efficacy of the machine. Lately, the demands for increased efficiency have diminished as the CDM has improved substantially. In addition, it must be said, the focus has been on CDM demand and the continuity of the CDM. However, one of the reasons there is competition for the CDM is that there have been serious issues raised about the process, which, is seen as overly complex and unpredictable.
49. **Digitization.** The CDM project cycle is complex, with many steps and substantial amounts of documentation. Digitizing the CDM project cycle has been one solution that was proposed but never followed up on. The main aim of digitization of documents is to minimize the potential for human errors during manual data transfers and the time needed to review lengthy technical documents for language and consistency. In addition digitization of the complete data generation and reporting process could facilitate automated checks of parameter compliance within a certain range, trend analysis across different projects or monitoring periods,



comparison of monitored versus Project Design Document (PDD) predictions of reduction volumes or activity levels. The first focus should be on digitizing the verification process, followed by digitization of the PDD Development, validation and registration process.

50. **Excess issuance** is one of the provisions in the Marrakech Accords that was never implemented. Efforts of the last few years there have been sustained efforts to provide further CMP guidance, but an outcome during CMP negotiations was gridlocked. It is felt by some that this is one aspect that should be addressed by the Appeals Process. Another critical issue is under what circumstances would someone be held liable, and who that would be. This is an issue that needs to be addressed by the M&P review.
51. We feel that there is not a single solution to this problem. Those that have responsibility for the excess issuance should be held liable, but that liability must have a sunset.
52. If excess issuance is the result of a faulty methodology, it should be made up through a reserve pool where credits are held for a defined period of time, when the issuance can be appealed.
53. If the excess issuance is the result of faulty data or errors in work by the Designated Operational Entities then that entity or the Project Proponent should be held liable.
54. **Communication** between stakeholders and the regulator is an important element to ensure that the CDM regulatory machine works efficiently. This has now become part of the CDM process but at some of the important points it is operational at the latitude of the regulator. As part of this review process an analysis should be made of the usage that had been made of the existing provisions and whether changes should be made as part of the general overhaul.

#### Remarks

55. There are a number of technical improvements that the CDM cycle can undergo, which have been spelled out in other submissions. The CEPS submission, as mentioned earlier, will address broader themes and will not make . In this context, the CDM needs to ensure that the balance between environmental risk and investor risk. Multilayer processes that ensure total environmental certainty at the expense of increased business risk have made the CDM a very complex process.

#### *Governance.*

56. Experience shows that changes to the CDM can only be initiated once a year, through the "CMP Guidance to the CDM EB document". In many cases, issues are simply postponed from year to year, for lack of time, or the inability of the CMP to make decisions. Also, this takes place through CMP process, which can only act through consensus. That is understandable for matters that are of a political nature.
57. However, the CDM is a market instrument, which has evolved to a large degree through a learning-by-doing process. Many issues that have been brought before the CMP are of a political nature (e.g. what is the scope of the CDM). However, many issues are not political, but rather operational and technical. In such cases a

faster process, and one that can act without being held hostage to the consensus process must be available.

58. This review of the M&P should examine if there are other ways to direct the EB. One possibility would be allow the Contact Group to continue work and examine items at the SBs, which meet between two CMP meetings. In addition, could Rules of Procedure be considered for this item, given its special regulatory nature?
59. Much progress has been made in this direction, but it is still not applied in a consistent manner. The regulator, the CDM EB, continues to be heavily politicised, with individual members sometimes bringing in national agendas.
60. The CDM processes have been simplified and clarified by a good degree. However, it still is, once in a while, ignored when it gets in the way of the political agenda. The main remedy lies in the choice of the members of the Board that are at present closely connected to the UNFCCC negotiating process.
61. Selection of the EB should be guided by very stringent rules that should emphasise regulatory experience and ensure detachment from the agenda of the UNFCCC negotiating process. Since this is a UN body, nominations can only emerge from regional groups, but they should be subject to approval by the CMP (Conference of Parties serving as the meeting of the Parties to the Kyoto Protocol) under clearly defined guidelines. This, combined with terms limits, may contribute to creating a less politicised Board.
62. The current situation whereby there are 10 full CDM EB members and ten alternates does not reflect the operational realities of the Board and should be changed to 20 full members.
63. The Secretariat of the CDM EB should continue to operate under UNFCCC Sec rules but should have its own Head, reporting to the Chair of the CDM EB.
64. The Chair and Vice Chair of the EB should be full time positions.
65. Also as part of the governance, an appeals process and a grievance mechanism are long-overdue necessities. Instructions had been given by the CMP in Copenhagen to develop such a mechanism. A bad appeals mechanism can become a weapon to create mass gridlock for the CDM.