Submission by Nauru on behalf of the Alliance of Small Island States (AOSIS)

New market-based mechanism: views on role and technical design

November 12, 2013

Decision 1/CP.18, paragraph 50, requested SBSTA to conduct a work programme to elaborate modalities and procedures for the New Market-based Mechanism defined in decision 2/CP.17, paragraph 83, with a view to recommending a draft decision to the COP19. The Republic of Nauru welcomes the opportunity to present the views of the Alliance of Small Island States (AOSIS) on the questions referred to in, inter alia, paragraphs 4 and 5 of FCCC/SBSTA/2013/L.8[1] with respect to the role and technical design of the New Market-based Mechanism.

1. Introduction

This submission builds upon AOSIS's previous submissions on this issue, FCCC/AWGLCA/2011/MISC.2 at 40-47 and FCCC/AWGLCA/2012/MISC.6 at 31-40.

2. Role of the New Market-based Mechanism (NMM)

(a) In which aspects is the NMM different from existing market-based mechanisms?

The New Market Based Mechanism will be different from existing mechanisms insofar as it will:

- be structured to deliver both net domestic (sectoral or economy-wide) and substantial net global emission reductions, through a design that moves beyond mere offsetting of developed country Party emissions
- create opportunities and financial incentives for developing country Parties to participate in international emissions trading if they so choose, on an economy-wide or sectoral basis directly under the UNFCCC, without having to adopt Annex I Party status and an economy-wide emission limitation or reduction commitment, as required under the Kyoto Protocol.
- secure real, measurable, verifiable and additional, long-term net global emission reductions on a larger scale than the CDM, while allowing a project-specific only approach for some host countries.
- establish crediting thresholds or sectoral caps on a voluntary basis for developing countries, below historical or BAU emission levels.
- generate units that will be available for use toward compliance obligations under the Convention, in the context of legally-binding economy-wide emission reduction commitments of developed country Parties
- provide transparency on which Party receives recognition for which emission reductions and transparency on the scale of net emission reductions the atmosphere sees as a result of its operation.

(b) Is there a relationship between a Party's level of mitigation ambition and its use of the NMM and, if so, what is the appropriate relationship?

Developed countries with legally-binding economy wide commitments in place under the Convention will be able to draw on units from the New Market-based Mechanism for up to a portion of their planned emission reductions, within the quantitative limits of the supplementarity rule that is to be agreed. The deeper their emission reduction commitments, the more they will be able to rely on units from the NMM. **Developing countries** will benefit more from the financial incentive

[1] http://unfccc.int/resource/docs/2013/sbsta/eng/l08.pb3df

provided by the NMM the deeper their sectoral emissions reductions are below agreed crediting baselines or the deeper their reductions are below agreed sectoral caps; more ambitious reductions will generate a greater number of credited units or tradable surplus units with market value.

Regardless, the NMM will not succeed in driving emission reductions in developing countries without **far more ambitious, internationally legally-binding mitigation commitments** in place in developed countries, to create a market for the resulting units.

(c) What are the links between the NMM and other relevant matters under the Convention and its instruments?

The NMM is linked to the FVA and the establishment of a set of common accounting rules under the Convention. Institutions established to support the NMM under the Convention will have to ensure no double counting between emission reductions generated under the NMM and the CDM and no double counting of emission reductions between non-market based approaches established under the Convention and the New Market Mechanism. Eligibility requirements for the NMM will link to provisions on monitoring, reporting and verification under the Convention and Protocol. To the extent Parties require financial and technical assistance to participate in the NMM, discussions under the CGE may also be linked.

The NMM is also related to Kyoto Protocol rules and institutions, which will establish criteria for the use of Convention units against Kyoto commitments for the second commitment period. A system will be needed to track units that have been found to be eligible for use toward these commitments and to ensure that units that do not meet agreed criteria are not allowed for this purpose.

(d) How can the consistency of the NMM with the objective, principles and provisions of the Convention, with the science of climate change and with environmental integrity be ensured?

To be consistent with the objective, principles and provisions of the Convention and with the science of climate change, the New Market-based Mechanism must ensure real, measurable and permanent emission reductions, and go beyond offsetting to achieve **substantial net global emission reductions**.

Application of the principles of **CBDR and equity** can be ensured by providing capacity building assistance and technical assistance to developing country Parties that are interested in participating in the NMM. This support could include, for example: assistance in collecting sectoral baseline data; developing a time series of emissions; establishing regulatory systems for data collection or for monitoring, reporting and verifying emissions; preparing reports that propose sectoral caps or crediting thresholds; and /or assistance in establishing national registries or links to a centralized registry adopted or adapted under the Convention.

Environmental integrity requires the establishment of **common accounting rules and institutional oversight mechanisms at the international level** to: guide and oversee approval of proposed sectoral caps and crediting thresholds; oversee the issuance of NMM units; oversee the application of internationally-approved methodologies; oversee third party technical reviews of inventories and proposed baselines and caps; ensure that the NMM delivers a net domestic reduction in the relevant sector of the host country as well as net global emission reduction upon use; and **confirm that eligibility criteria, qualitative standards and quantitative limits** are met before transfers of units are allowed.

5. On the technical design of the NMM:

(a) Its operation under the guidance and authority of the COP: how should the COP exercise its guidance and authority over the NMM, what should the institutional arrangements for the NMM be, and what should the role of the UNFCCC be in relation to the individual Parties that implement the NMM?

The NMM must operate under the guidance and authority of the COP, to ensure environmental integrity of the commitments adopted by Parties and the environmental integrity of the regime as a whole. The COP should exercise its authority through the establishment of a robust common accounting system, applied by and through institutions that remain under the guidance and authority of the COP.

Institutional arrangements for the NMM should be established and operate under the guidance and authority of the COP. They should ensure environmental integrity by **adopting and building upon on current eligibility requirements under the Kyoto Protocol Articles 5, 7, 8 and 18** (inter alia, initial reports, unit-based accounting, reliable national systems to estimate emissions, third party technical reviews of inventories, reliable national and/or centralized registries to hold and track NMM units, application of eligibility requirements for the issuance, transfer, acquisition and retirement of units, and a compliance system to assess whether eligibility requirements have been met or maintained, and whether sectoral targets and caps have been exceeded).

The role of the COP, and institutions under the guidance and authority of the COP, with respect to individual Parties should be to:

- oversee application of eligibility criteria
- oversee technical review of proposed baselines, crediting thresholds, caps and relevant inventories
- ensure that the registries on which units are held meet criteria established by the COP
- ensure that transfers are checked for conformity with technical standards
- checks transfers of units to ensure that agreed quantitative and qualitative criteria are satisfied prior to the transfer of units between Parties
- oversee the issuance of new market mechanism units and credits
- ensure the delivery of a share of proceeds of the NMM for the adaptation needs of particularly vulnerable developing country Parties
- assess whether targets and caps have been exceeded.

(b) The voluntary participation of Parties in the mechanism: how should this be ensured, and how can the NMM incentivize wider Party participation?

The voluntary participation of Parties can be ensured by inviting developing country Parties to indicate in what broad sector or sectors they may wish to participate and to indicate the type of capacity building or technical assistance they may need to bring forward or propose sectoral caps or sectoral crediting thresholds with appropriate supporting information.

The NMM can incentivize wider Party participation by generating credible units, delivering net global emission reductions, ensuring that capacity building and technical support is available, and ensuring that there is a market for the units and/or credits that are generated. The NMM can also incentivize participation by putting in place support systems to assist developing countries in achieving their goals, given recognition if they succeed and not unduly penalized if they do not succeed.

(c) Standards that 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: what are these standards, how should they be developed and applied, and what lessons should be learned from other experience, including under the Kyoto Protocol?

The Parties to the **Kyoto Protocol** have already adopted **standards** that are designed to deliver real, permanent, additional and verified mitigation outcomes on a project-by-project basis under CDM and JI, but only for offsetting purposes - not for the purpose of generating net global GHG reductions. New standards are needed to ensure the delivery of **substantial net global emission reductions** through use of the NMM.

While International emissions trading under Article 17 of the Protocol aimed to generate flexibility by allowing for the trading of emission allowances between Parties, due to surplus AAUs in the system, this flexibility eroded the emission reductions the atmosphere might otherwise have seen from first commitment period targets. Much stronger centralized oversight and more stringent standards will be needed in the context of sectoral trading if the NMM is to contribute to genuine global emission reductions. More stringent standards must be developed and applied to sectoral approaches for developing countries **to ensure that any units generated embody net domestic emission reductions (in the case of sectoral crediting), do not reflect hot air (in the case of sectoral trading) and also generate a net global reduction in emissions when tendered toward compliance obligations**. Options for ensuring net reductions at both the domestic and global levels, which may be combined, include:

- **Conservative baselines**, set at a fixed percentage below verified BAU projections (e.g., 20% or 30% below BAU projections)
- **Sectoral baselines set below absolute emissions**, averaged over a fixed time period preceding the trading/crediting period (e.g., average 2008-2010 emissions) for emission reductions to be delivered over a fixed timeframe (e.g., 2013-2020)
- **Discounting of units when generated or traded**, at a rate that will ensure that the units generated lead to, or the units traded reflect, a substantial net benefit to the environment
- **Setting aside a portion of units generated for the benefit of the environment** through the international transactions log (e.g., W% set aside for the environment; X% available for acquisition through the international transactions log; Y% credited to host Party emission reduction goals; Z% contributed as share of proceeds to the Adaptation Fund). [2]

Technical papers from the Secretariat could assist the Parties by identifying options for achieving substantial net global emission reductions and their quantitative implications (e.g., discounting, set aside of units, conservative baselines set X% below BAU, etc.) and the impacts on closing the gap in mitigation ambition that may result from each.

The results of efforts under Articles 6, 12 and 17 of the Protocol demonstrate how essential it is to have strong, centralized, international oversight over any processes that generate tradable units that can be used to satisfy compliance obligations. The CDM, JI and IET have all benefited from checks on the quality of units traded or generated, and checks on the quality of Party inventories and accounting systems, and the possibility of raising questions related to implementation.

[2] See AOSIS Submission, FCCC/AWGLCA/2012/MISC.6 at 38.

(d) Requirements for the accurate measurement, reporting and verification of emission reductions, emission removals and/or avoided emissions: what are these requirements, how should they be applied, and what lessons should be learned from other experience, including under the Kyoto Protocol?

Requirements for the accurate measurement, reporting and verification of emission reductions include: budget-based emissions accounting, annual inventories subject to third party review, adjustment procedures applied where necessary to prevent over- or underestimation of emissions, annual reports on unit holdings, standards for the identification of units (e.g., unique serial numbers, vintages, identification of the source of the unit), national or centralized institutions for tracking transfers and acquisitions of units that meet internationally-agreed standards, conformity checks to ensure qualitative and quantitative standards are met, processes for end of period compliance assessments, international oversight to ensure reliable national arrangements for estimating emissions and removals, and a compliance system to ensure that eligibility requirements for trading are satisfied.

(e) Means to stimulate mitigation across broad segments of the economy, which are defined by the participating Parties and may be on a sectoral and/or project-specific basis: what are examples of such segments, how should the NMM stimulate mitigation within them, and on what basis should the participating Parties define them?

The most promising broad segments of the economy for voluntary inclusion in sectoral trading or sectoral crediting under the New Market Mechanism would be those in which: (1) substantial emission reductions need to be achieved; (2) data is readily available; (3) the degree of uncertainty in emission estimates is low; (4) substantial potential to contribute to the host country's sustainable development is present; and (5) it can be shown that real and additional reductions in emissions that would otherwise have occurred to the atmosphere can be achieved.

These considerations support the creation of opportunities for voluntary developing country participation in sectoral trading and crediting approaches within the **energy sector (power generation) and for industrial emissions (e.g., iron and steel production, cement production)**. The power generation sector typically has few players in each country, significant investments will be needed, and data is more likely to be readily available to governments than in other sectors. For certain industrial sectors, such as iron and steel production and cement production, reliable data is also likely to be available and opportunities for realizing emission reductions are well known.

The **transport sector** may be amenable to inclusion in certain countries if sectoral boundaries can be established. The **forestry sector** may be more challenging to include, given the enormous data uncertainties in this sector, the large swings in annual emissions due to year-to-year variability in the climate, and the increasing likelihood of large-scale carbon stock losses due to the consequences of projected climate change itself.[3] Policies that support emission reductions in the LULUCF sector or reduced emissions from deforestation and forest degradation (REDD) may benefit in the near term from non-market based financing mechanisms, or from a system that is clearly segregated from the trading of units representing emission reductions from the power generation or industrial sectors.

[3] These uncertainties have been seen in Annex I Party reporting in this area, and the impacts on inventories of so-called "non-human induced" impacts in the sector such as droughts and fires.

(f) Criteria, including the application of conservative methods, for the establishment, approval and periodic adjustment of ambitious reference levels (crediting thresholds and/or trading caps) and for the periodic issuance of units based on mitigation below a crediting threshold or based on a trading cap: what are these criteria and how should they be applied?

Criteria for the establishment and approval of ambitious reference levels could include: (1) presentation of reference levels that are below historical emission levels; (2) presentation of reference levels that are a more than a fixed percentage below business as usual emission levels (e.g., 10%, 20%). Caps and baselines should be set to ensure that the operation of the NMM in a given segment of an economy will deliver substantial net domestic reductions relative to baselines. Sectors will have to have clear boundaries and be designed to avoid leakage outside these boundaries.

Reference levels will have to be based upon a consistent time series of emissions in tonnes from a given sector with a defined and consistent geographic scope. Emissions data and any relevant indicators should be based upon publicly available information to the extent possible and reference levels should always be set substantially below the annual variation in sectoral emissions. **Periodic adjustments** to objective indicators may be needed, but reference levels should not allow for additional emissions beyond budgeted emissions for the relevant period, or redefine the scope of the covered sector during a trading or crediting period.

(g) Criteria for the accurate and consistent recording and tracking of units: what are these criteria, how should they be applied, what technical systems need to be in place and what lessons should be learned from other experience, including under the Kyoto Protocol?

Criteria include, inter alia, budget based accounting, unique identifiers for units that indicates vintage and source, approved national registries and centralized tracking systems, centralized conformity checks, third party reviews of registries and inventories, and international oversight by the COP. The possibility must be in place for the suspension of issuance or trade where eligibility requirements or other standards are not satisfied, to protect the environmental integrity of the trading system as a whole.

(h) Supplementarity: should this be defined and ensured and, if so, how?

Supplementarity should be defined to ensure that at least half (50%) of each Party’s emission reduction commitment, in tonnes of emissions to be reduced, is secured domestically, rather than through the tendering of units from market based mechanisms representing reductions achieved outside that Party’s borders. Supplementarity can be ensured by converting each Party's commitment into units representing tonnes of intended emission reductions at the outset of the period of commitment.

(i) A share of proceeds to cover administrative expenses and assist developing country Parties that are particularly vulnerable to the adverse effects of climate change to meet the costs of adaptation: should there be a share of proceeds and, if so, how should it be structured and applied and at what level should it be set?

A share of the proceeds should be directed from the New Market-based Mechanism under the Convention to the Adaptation Fund, to support the adaptation needs of countries particularly vulnerable to the adverse impacts of climate change. The share of proceeds may be drawn from all credits issued as a result of reductions below crediting thresholds, and drawn from the units issued under sectoral caps at the time these are transferred from the host country’s registry to another Party. The percentage dedicated to a share of proceeds for adaptation **should be 5%.**

(j) The promotion of sustainable development: how can the NMM promote this?

It is the host country's prerogative to determine whether the NMM promotes sustainable development. If there is a project-based aspect to the NMM, there should be protections in place that are no less strict than under the CDM with respect to stakeholder consultations, the granting and withdrawal of letters of approval, and the possibility of appeals.

(k) The facilitation of the effective participation of private and public entities: how should the NMM facilitate such participation and how can its incentives be structured appropriately?

The participation of private and public entities will be facilitated by the COP's **adoption of clear modalities, procedures and accounting rules** for the NMM, including **credible, centralized institutions** to review and establish proposed baselines, sectoral crediting thresholds and sectoral caps at the international level. The adoption of **ambitious, legally-binding mitigation commitments** at the international level and regulatory systems at the national level to deliver these reductions will give further confidence to the private sector. Participation can be incentivized by **ensuring that a market and price exists** for units representing the achievement of reductions below a sectoral crediting threshold or below a sectoral cap.

(l) The facilitation of the prompt start of the mechanism: what measures should be taken to facilitate the prompt start of the NMM and what criteria should be in place?

A prompt start of the NMM should take place only after, inter alia: the NMM has been structured to deliver substantial net global emission reductions (go well beyond offsetting); a numerical share of the proceeds for adaptation has been agreed; it has been clarified where NMM units will be issued and held (e.g., centralized registry and/or national registries); a technical body has been established under the UNFCCC to review proposed caps and crediting thresholds and to review registries as necessary; a body has been established under the UNFCCC to assess the achievement of these caps or thresholds; common accounting rules are in place to avoid the double counting of NMM units; and a decision has been made for which trading period any NMM units that are credited will be valid. Once these elements are in place or agreed, to facilitate a prompt start to the NMM developing country Parties should be invited to propose sectors for possible inclusion in the NMM and possible sectoral caps or crediting thresholds that are significantly below business as usual projections or historical emissions.

(m) Eligibility criteria for the use of the mechanism: should there be such criteria and, if so, what are they and how and to whom should they be applied?

Eligibility criteria should be in place both for developing countries wishing to participate in the mechanism and for developed countries wishing to use NMM units toward their internationally legally binding commitments.

To be eligible, **developing country Parties** voluntarily wishing to participate in the NMM should be required to, among other things:

- present a sectoral or economy-wide target that is significantly below business as usual projections
- present an adequate time series of sectoral or economy-wide emissions, based on a consistent methodology, reported according to agreed IPCC methodologies
- allow a technical review of baselines, targets and inscribed amounts at the international level by sectoral experts, drawn from the UNFCCC roster of experts, which could be facilitated by the Consultative Group of Experts on Non-Annex I Communications

- have in place a national system or national arrangements for the reliable estimation of anthropogenic emissions by sources and removals by sinks
- report regularly on sectoral emissions and national emissions
- maintain inscribed amount and/or units, once issued, in an approved registry
- put procedures in place to avoid double counting of emission reductions
- subject their relevant inventories to a technical review to determine whether they have achieved their sectoral or project/based targets.

For **developed countries**, the same eligibility requirements that now exist under the Kyoto Protocol for Annex I Parties to acquire or transfer units, would apply equally to the acquisition and transfer of any units created through new market mechanisms to be used for compliance purposes. Developed countries should be required to, among other things:

- have an internationally-legally-binding, single number, economy-wide emission reduction commitment in place
- have calculated and recorded their emissions budget for the commitment period in tonnes of CO2-equivalent emissions
- have in place a national system or national arrangements for the estimation of anthropogenic emissions by sources and removals by sinks
- have in place a national registry
- submit annual GHG inventories for a technical review
- submit supplementary information to demonstrate progress toward achieving economy-wide emission reduction commitments and targets
- submit information on annual holdings of units
- have procedures in place to avoid the double counting of emission reductions
- subject their annual inventories to a third party review as stringent as the Article 8 review now in place for Kyoto Protocol Parties
- subject their inventories to an end of period technical review to determine whether holdings of units are sufficient to cover commitment period emissions and take any required remedial action.

(n) Role of the implementing Party: what should be the role of the implementing Party in the operation of the NMM?

The role of a developing country Party, wishing to generating units under the UNFCCC that are recognized for compliance purposes under the UNFCCC, should be to:

- identify a promising domestic sector or sectors for inclusion in either a voluntary sectoral trading or crediting mechanism,
- present a sectoral or economy-wide target for a fixed time period that is significantly below business as usual projections or below absolute historical emissions
- present an adequate time series of sectoral or economy-wide emissions, based on a consistent methodology, reported according to agreed IPCC methodologies, to support the proposed sectoral or economy-wide target
- allow an initial third party technical review of baselines, targets and inscribed amounts (for sectoral or economy-wide trading) at the international level, by sectoral experts, drawn from the UNFCCC roster of experts
- maintain reliable national arrangements for the estimation of anthropogenic emissions by sources and removals by sinks
- report regularly on sectoral emissions and national emissions
- maintain an inscribed amount and/or units, once issued, in an approved registry
- put procedures in place to avoid double counting of emission reductions

- subject relevant inventories to an-end-of period third party technical review to determine whether a sufficient number of units are held to cover commitment period emissions (in the case of sectoral trading), or whether emissions have been reduced below a crediting threshold and by how much.

(o) Governance: what measures can be taken to ensure the good governance of the NMM?

The good governance of the NMM can be supported by building on the procedures and institutional structures established to support international emissions trading under the Kyoto Protocol. These include, inter alia: operation under the guidance and authority of the COP; the engagement of independent third party reviewers for technical reviews of baselines and inventories; the adoption of transparent modalities and procedures applicable to all participating developing country Parties, agreed at the international level under the UNFCCC; the adoption of eligibility requirements; the establishment or use of transparent institutions capable of tracking trades in units and applying conformity checks. Good governance will also be supported by the adoption of capacity building measures to assist developing countries in meeting eligibility requirements.