Climate Markets & Investment Association

PROJECT DEVELOPER FORUM

# Submission to Subsidiary Body for Scientific and Technical Advice

## On the role and technical design of the New Market Mechanism

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## Introduction

PD Forum and CMIA consider the New Market Mechanism to be a Carbon Market Mechanism that results in the transfer of emission allowances and emission reductions between participating entities. It is distinct from, for example a tax or a subsidy which are market based mechanisms in broader economic terms.

The New Market Mechanism (NMM) sits under the Framework of Various Approaches (FVA) which is an **umbrella of minimum standards** designed to provide guidance and tools to help Parties to the UNFCCC implement emission management activities which are comparable. (See PD Forum and CMIA's submission on the FVA for more details).

With respect to the new market mechanism, one of those minimum standards will be that sectors or groups of facilities which wish to participate in the new market mechanism will need to operate under an emission allocation process with a functional registry in order to ensure the environmental integrity of the mechanism. Parties that do not operate under such conditions can use the CDM whilst Parties which have economy wide caps can utilize JI.

## Response to call for input

## On the role of the NMM

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

There are already three market mechanisms under the regulation of the UNFCCC – CDM, JI and IET. CDM applies to countries without economy wide caps and requires individual projects to establish additionality on a project by project basis. JI applies to capped economies and in theory relies less on the proof of additionality because AAUs are cancelled to match issued ERUs – though in practice buyers have expressed a desire to track 2 issuance procedures which also ensure additionality. IET is for international trade in AAUs between capped Parties.

The PD Forum and CMIA propose that the New Market Mechanism differs from these existing mechanism by allowing sectors or groups of facilities whose emissions are recorded within a functioning registry to participate in transactions where any international transfer of emission reductions is backed by a corresponding cancellation of emission allowances in the registry. In this way, additionality can be established for a sector or group of facilities by means of the fulfillment of eligibility criteria. This approach would allow groups of facilities or sectors of an un-capped economy to participate in JI style projects and transfer of allowances.

We also wish to note that the CDM has the potential to provide for projects at a sectoral level through the application of standardized baselines and PoA.

### (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?

PD Forum and CMIA propose that the new market mechanism can be used as a mean of developing and implementing host country mitigation, in a supported manner whereby the support comes in the early years of the implementation of the program whilst in the later years support from the international sale of emission reductions is curtailed and the emission reductions are either directed into the host economy or subsumed into national accounting. This could be implemented by defining the maximum crediting period for activities under the new market mechanism.

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

There must be very strong links between all mechanisms under the Framework of Various Approaches to ensure that there is consistency between mechanisms and there are no incentives to game the mechanisms for financial benefit or to the detriment of the environment.

### (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?

A new market mechanism, if it is to provide emission reductions for international trade, must follow the same principles as CDM and JI – emission reductions must be real, permanent and additional and subject to third party independent inspection. All of these issues have already been addressed under the CDM and JI and there are many **common building blocks** which can be directly applied to a new market mechanism. If a market mechanism is used for internal mitigation purposes then it is not necessarily captured by these rules but it should still be governed by guidance under the FVA.

## 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 PD Forum and CMIA propose that a new market mechanism is developed and implemented under the control of an Executive Board similar in structure and operation to the CDM Executive Board. Both the CDM EB and the JISC and their support structures have developed over a decade of experience in managing the CDM and JI and have created a substantial repository of procedures and tools which may be used as an open source for the creation of a new market mechanism. Indeed, if the COP saw fit, they could increase to role of the existing CDM EB or the JISC to include the management of the new market mechanism. This might entail making some positions on the Board permanent and would require the complete separation of Board representatives from country negotiators and DNA representatives.

### (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 aspect of participation is not difficult. There should be no specific requirement for Parties to participate in the NMM, as with the CDM and JI at present. Broader participation may be encouraged by helping host parties to see the benefits and to realize the benefits of participating in a NMM. At present, host countries benefit relatively little from the CDM and JI and projects are only developed if external entities (Parties or the private sector) wish to invest. Greater participation could be encouraged if;

a) Greater support is given to help Parties overcome the higher levels of political risk which represent barriers to private sector investment in low carbon technologies
b) Parties are able to showcase low carbon technology via NMM activities such that it would help them meet legally binding targets in the future.
c) The relationship between E- policies and generation of emission reductions for sale is made explicitly clear – such that a Party can define a policy with a deadline for implementation with the knowledge that any emission reductions arising from investment and operation of technology ahead of the implementation deadline are additional and can be sold on the international markets
d) Financial assistance is made available to protect the intellectual property rights and support the additional costs associated with low carbon technology, and that these costs can be largely repaid from the sales of the resulting emission reductions

e) Related to d) above, Parties create sufficient demand for emission reductions and put in place a back-up mechanism. If there is inadequate demand from buying nations, then a central agency such as an International Carbon Bank would be required to step in and purchase the resulting emissions at a pre-defined floor price.

### (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?

As a principle, participating parties should act under a cap and where this is not the case, sectors should be covered by an emission inventory.

The standards will include concepts such as standardized baselines and MRV standards, standardized ways of dealing with accuracy, uncertainty and conservativeness, standards for accreditation of independent entities etc.

PD Forum and CMIA also propose that additionality is standardized for the new market mechanism, on the basis that establishing additionliaty on a project by project basis is not compatible with objective of applying the new market mechanism to sectors or groups of facilities. As mentioned above, one essential criterion is that all participants in the new market mechanism have their emissions administered via a registry so that international transfers of emission reductions or allowances can be matched by cancelation of allowances in the registry. Other criteria could be based on principles such as:

- Verified baseline and relevant facility data reported and held on the registry
- Internal capacity building completed (eg. training in MRV)
- All data verified by accredited by independent entities

### (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?

There is plenty of experience in efficient and inefficient measurement and reporting of GHG emissions from the CDM, JI and various ETS around the world. Emphasis should be on the creation of efficient, rational and accurate measurement and reporting in a transparent and accountable manner.

### (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?

PD Forum and CMIA consider that sectors with concentrated emission sources are best suited for NMM.

If the NMM included for example stationary combustion, it could be used as a soft-start tool to finance technology upgrade and manage political risk for investors and Ip providers over, for example a 7 or 14 year period before the implementation of a domestic emission trading scheme. Sectors with fewer than perhaps 20 participants may be better suited to a project based approach using the CDM because the institutional effort of setting up a sectoral scheme may be too difficult. Similarly, sectors with highly variable technology might be better suited to a project based approach since standardized approaches in heterogeneous groups tend to create winners and losers, making them difficult to develop at a political level.

### (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?

Conservativeness factors should be applied at the end of the measurement and reporting process in a transparent manner such that conservativeness is spread fairly across all technologies. Periodic adjustment of reference levels is less important if shorter crediting periods are applied. PD Forum and CMIA consider that defining crediting thresholds for individual NMM initiatives may prove challenging and we would like to refer to our proposal on introducing mitigation into the CDM as a possible model for the NMM as well (see http://www.pd-forum.net/files/ed84473f99c954b735e348b742e5c643.pdf). In managing mitigation and crediting, we would also like to highlight the importance of early cash flows to investors and the benefits which may arise from front-loading the issuance of tradable units whilst back-loading the mitigation benefits.

### (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?

This is addressed by making the establishment and use of registries by all of the participants in a defined sector an eligibility criterion.

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

Supplementarity is an issue for Parties that seek to purchase allowances or emission reductions in order to meet their targets. It is less of an issue for Parties that may wish to participate in NMM. For Parties hosting NMM activities, supplementarity is addressed by limiting the crediting period such that after a pre-defined period, all of the activity is directed towards host country mitigation. Under this approach, the NMM is a tool to help Parties finance the transition to a low carbon strategy.

## (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 proceeds may be collected to cover admin costs; or another approach may be adopted such as direct finance from an international agency such as the Green Climate Fund. There is no particular need for a share of proceeds for an adaptation fund as this is simply a tax on the system which may act to discourage investment. If the Parties wish to generate revenues for adaptation, they might consider taxing economic sectors which do not implement emission reducing activities, or taxing trade in items which cause GHG emissions. Such an approach is closer to the principle whereby the polluter pays, rather than the current situation where those who are actively investing to reduce pollution pay. In short, Parties should tax emissions not mitigation.

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

If Host Parties have a greater incentive to develop their own NMM then the requirement for contribution to sustainable development is less important. As in the CDM and JI, contribution to sustainable development is a sovereign issue. Nevertheless, there should be a negative list of technologies which cannot be supported by the sale of tradable emission reductions and this might include construction of fossil fuel plant in certain circumstances. The COP might consider the role of nuclear. Alternatively, the Parties might agree that anything which reduces reliance on fossil fuels contributes to sustainable development or make a “do no harm” assessment part of the eligibility criteria.

## (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?

If there is a clear demand for emission reductions and a mechanism for financing technology change under a NMM, then PD Forum and CMIA believe that both private and public entities will be incentivized to participate. However, it is important that the mechanism places adequate emphasis on the rule of law such that, for example, rights to appeal against decisions, independence of decision makers, steps to avoid the retrospective application of laws are put in place. The mechanism must also be transparent.

## (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 should be encouraged from, for example 2015, but care should be taken to ensure that prompt start activities meet the eligibility criteria and that they do not in some way benefit from an early lack of understanding of the scope and implication of the NMM; for example, they might be subject to a review after a period of 5 years during which baselines and eligibility may be re-assessed.

## (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?

Yes, see above. We propose that these are used to replace an additionality test on the basis that the long term benefit to a host country and global GHG emissions will quickly overtake any non-additional emission reductions which are issued and traded as part of the financing mechanism and that proving additionality for individual participant within a sector or group is not practical.

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

The implementing Party has a substantial role around the creation of the necessary institutional infrastructure to support the NMM. These responsibilities are reflected in the eligibility criteria and the establishment of a standardized baseline. Many developing and least developed countries will need significant assistance in setting up this infrastructure. The implementing Party will also need to pass legislation to create the groups / sectors and impose regulations on participants. Depending on how a specific NMM is structured, it may be necessary to manage the group and transact the sale of emission reductions on behalf of the group. The Ministry of Energy or Ministry of Industry is likely to take a significant role alongside a Designated National Authority.

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

If a Board is to be established then it may be necessary to make the board permanent and most importantly, to ensure that it is independent of the Parties and that it does not include negotiators and DNA representatives. The appointment process might be reviewed to ensure that suitably qualified and competent staff are appointed, for example professional staff including some with private sector experience