



Submission by Hungary and the European Commission on behalf of the European Union and its Member States

This submission is supported by Albania, Bosnia and Herzegovina, Croatia, Iceland, the Former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey.

Budapest, 23 March, 2011

Subject: The concept of Materiality in the CDM

Introduction

1. We welcome the decision on CDM CMP6 in Cancun to request the Subsidiary Body for Scientific and Technical Advice to consider the issue of materiality and we look forward to engaging in discussions with other Parties at the meeting of the Subsidiary Body for Scientific and Technical Advice in June.
2. Despite its technical nature, this is indeed an important issue and we look forward to a timely implementation of the materiality concept in the CDM, noting the mandate assigned by the CMP to the Executive Board at CMP5 (decision 2/CMP.5, paragraph 22), and we welcome the draft standard on the use of the concept of materiality in the CDM¹.
3. Progress on the application of materiality in the CDM is essential in order to enhance the efficiency, consistency and predictability of the CDM process. The concept of materiality is well known to the carbon market, including in the Kyoto project-based mechanisms and the concept of materiality in verification of JI projects was adopted by the JISC in June 2010². In the European Union, the Emission Trading Scheme monitoring and reporting of emissions is also conducted with an assessment of materiality of emission reductions.

¹ Draft Standard on the Use of the Concept of Materiality and Level of Assurance in the Clean Development Mechanisms” EB 56 Proposed agenda. Annotations Annex 2.

² Standard for Applying the Concept of Materiality in Verifications (Version 01)” adopted on June 16, 2010 at the 22nd meeting of the JISC.

1.1.1 Definition of Materiality

4. For the purpose of the emission monitoring and reporting in the context of the CDM, the proposed draft standard on Materiality adopts the International Accounting Standards Board (IASB) definition: "An information is **material** if its omission or misstatement could **influence** the economic **decisions** of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful." Having introduced in the EU legislation (2004/156 EC decision) the notion of 'materiality', meaning the professional judgment of the verifier as to whether an individual or aggregation of omissions, misrepresentations or errors that affects the information reported for an installation will reasonably influence the intended users' decisions.
5. In general, a 'materiality level', meaning the quantitative threshold or cut-off point, is one that could influence the decision making process made by the CDM EB with regard to registration of the CDM project or issuance of CERs from the project, consequentially to the application of the materiality threshold by a DOE. . This means that non-material issues, if in aggregate do not exceed the material threshold, are only those facts that are deemed insignificant for this decision and which would not have affected its outcome, "above the threshold level".
6. Threshold level means the quantitative threshold or cut-off point to be used to determine the appropriate verification opinion on the emission data reported (in the case of DOE) It should be pointed out that the threshold level, in the context of determining whether an issue is material or non-material, always relates to the potential impact, in relative terms, on emission reductions that could be claimed.

Scope of the application of materiality

7. The concept of materiality is present in the stages of validation, verification and review of a CDM project. As noted in the draft CDM EB standard, the concept of materiality is already taken into account in all CDM methodologies. The EU acknowledges that and recommends that further improvements should be considered. However, adopting a required threshold would increase the transparency and consistency of the myriad of judgements that have to be made by DOEs, secretariat and the EB and would result in a more predictable assessment overall. Applying a formal concept of materiality would increase transparency to each stage where the quantitative threshold or cut-off point is applicable in relation to a CDM project assessed: It should apply to the level of detail in the PDDs, validation and verification by DOEs but also in the review process and decisions by the Secretariat, the RIT and the CDM EB.

8. Materiality in relation to the review process will require that the EB, Secretariat and RIT consider the thresholds when deciding whether or not to send back a project document at completeness check or to trigger reviews of projects. Materiality in relation to decisions by the CDM EB requires that the EB considers the thresholds applied by a DOE when deciding on registration and issuance. Another problem that the EB has to take into serious consideration when addressing materiality, is how to prevent inconsistency between documents that can occur when non-material issues are ignored in each stage, for example between the PDD, the verification and the monitoring report.
9. The concept of materiality should be applied to both prescriptive and non-prescriptive CDM requirements as defined in the draft standard on materiality in the CDM.

Threshold for determining materiality

10. In the CDM EB draft standard on materiality it is stated that “information related to a CDM project is considered material if its omission might lead, at an aggregated level, to a total estimation of the emission reductions achieved by a CDM project equal or higher than:

- 0.5% of the emission reductions for projects achieving a total emission reduction – according to the PDD - of more than 500,000 tonnes of CO₂ equivalents per year;
- 2% of the emission reductions for large-scale projects achieving a total emission reduction – according to the PDD - of 500,000 tonnes of CO₂ equivalents per year or less;
- 5% of the emission reduction for small-scale projects.

In the draft standard on the use of the concept of materiality and level of assurance in CDM, the emission reductions achieved are per year and not based on average reported annual emissions like for instance in the EU-ETS. The EU can support the emission reduction per year approach as suggested for CDM in the draft standard. Furthermore, the EU proposes introducing a fourth level, applicable to micro-scale projects:

- 10% of the emission reduction for micro-scale projects (< 5 MW or 20 GWh/a).
11. The EU would like the CDM EB to report to the COP/MOP 7 on the implementation of materiality, experiences from the use of the thresholds and if there is reason for revision of the levels.

How to implement the materiality concept in practice

12. The CDM EB and its support structures should start implementing the concept of materiality in validation, verification and review stages of the CDM as soon as possible. It should report on the implementation of the materiality concept in conjunction with the annual report from the CDM EB to the CMP.

13. Applying the concept of materiality includes a proper documentation of the analysis made and the conclusions with regard to materiality drawn by the project developers and the DOE during the development of the project and the preparation of the relevant reports. For the EB and its support structure, appropriate justification for their decisions is also requested.
14. Materiality needs to be applied within the overall context of the CDM projects and Programs of Activities as a common understanding between the DOEs and the Secretariat and the EB. The materiality principle can be explained and accommodated by new instructions for drafting PDDs and by revisions in the Validation and Verification Manual. The DOE should apply the materiality level as part of its analysis in the validation/verification methodology under CDM. If an error is detected in how the validation and verification requirements have been applied, the error will have to be corrected but, if the potential impact of all of the mistakes are less than the given threshold, then it shall be considered immaterial and not influence the decision on the project by the CDM EB.
15. The concept of materiality may ease especially the situation for PoA under review according to the EB's procedures³. In case of a false inclusion of an activity by a DOE, the DOE should be liable for the amount of CERs resulting from the concerned activity only if the error in the sample is above the threshold values or if any error below the threshold values was concealed intentionally. In contrast, the DOE is not liable if it overlooked an error below the threshold. However, all detected errors have to be corrected and flawed activities have to be excluded. In this situation, a materiality standard will serve as a useful tool for DOE to focus their work and reduce their risks adequately, and by this way, remove a significant barrier for the widespread application of PoA in the CDM.
16. Minor (non-material) errors and omissions should be solved by simple, direct communication between the DOE and the Secretariat at the stages of the CDM project cycle where the materiality level is applicable, and not affect the assessment of compliance with validation and verification requirements nor lead to a determination that the request for registration or issuance is incomplete (building upon the decision of CMP 6, Further guidance relating to the clean development mechanism, para. 59).
17. In the CDM EB draft standard on materiality it is stated that “the level of assurance is a concept related to materiality. It defines the degree to which the DOE is confident in the validation or verification conclusion that the emission reduction claimed by a CDM project, taken as a whole, is free from material errors, omissions or misstatements”. The EU considers it important that the level of assurance be defined. An absolute level of assurance would mean that every parameter has been checked to ensure that every material error has been taken into account. This level of assurance cannot reasonably be asked. In the EU-ETS scheme, as well as in the VCS, the level verification opinion shall be based on a reasonable level of assurance. The EU would be in favour of using this standard.

³ Procedures for review of erroneous inclusion of a CPA, see:
http://cdm.unfccc.int/Reference/Procedures/PoA_proc02.pdf