CARBON MARKET FORUM

CEPS Thinking ahead for Europe

Views on the Framework for Various Approaches and the New Market Mechanism

Submission to the 40th session of the Subsidiary Body for Scientific and Technological Advice

19 September 2014

In its conclusions in June 2014, the 40th session of the Subsidiary Body for Scientific and Technological Advice (SBSTA 40) invited submissions on the Framework for Various Approaches (FVA), New Market Mechanism (NMM) and Non Market Approaches (NMA) by 22 September 2014.

This document is the submission by the Centre from European Policy Studies (CEPS) in response to that invitation, and covers both FVA and NMM. This submission should be seen in conjunction with previous work by CEPS in this area, notably submissions to the UNFCCC in March 2013and September 2013.

1. FVA, NMM and NMA in context

Why do we think these elements are a significant component of the 2015 agreement?

The 2015 climate change agreement will ensure that all Parties make contributions to combating climate change. However, from an economic- and emissions-profile point of view, the world is very different from what it was when the UNFCCC was negotiated in Rio in 1992, and from when the Kyoto Protocol (KP) was agreed in Kyoto in 1997.

In the context of the economic and financial crisis that we experienced over the last few years, which for many is not yet over, the issues of growth, competitiveness and equity have strong resonance. These issues are also important in the context of sustainable development.

There are many ways to look at whether this agreement will be successful or not, and many criteria to determine whether Parties are willing to sign it. The experience of the KP, with its significant absences, cannot be repeated.

One way to look at these issues is whether Parties will understand two important aspects of the agreement, namely:

- What does everyone promise to do through INDCs? What do the INDCs represent? In other words:
    - How do we define what we promise to do?
    - How do others understand what we promise to do?
    - How do we compare the effort required to deliver on the promises?
- How do we achieve what we promise to do? What are the means available to achieve what we promise to do?
    - Domestic reductions: captured through inventories
    - Internationally transferred mitigation credits:
        - Units
        - Mitigation outcomes

When the efforts are counted at the end of the compliance period, will there be clarity on these points? On inventories, there is an established body of knowledge.

Accounting was also well understood under the KP – how to count, and what to count. In the 'new' post-2020 world, under what sound reasonable assumptions, that may not be the case, and it is an issue that needs to be addressed.

This makes the FVA, and the approaches it covers, important elements of the 2015 agreement.

Finally, in the context of what gets counted towards compliance in any regulatory regime, we must remind ourselves of a fundamental rule of regulation: the regulator, that is the entity that accepts or imposes a commitment, is the only one entitled to decide what type of units are good for compliance.

A mitigation unit (CER, ERU, EUA) has two values: a monetary market value (decided by market actors), and a compliance value, which only the regulator can decide. In the case of the EU ETS, the EU, and not the COP, decides that a CER is a worth a ton. In the case of the 2015 agreement, the 'regulator' is the COP.

Assumptions

The role, scope, functions etc. of the FVA/NMM/NMA are going to be dependent on the architecture of the 2015 agreement. A 'loose' less centralised architecture will require fewer functions; a more centralised one may come close to mimicking the KP provisions.

The KP provisions, which triggered the rapid development and expansion of the carbon market, were relatively limited. They included:

- Articles 3.10 to 3.12, which provide the 'hook', the recognition to transfer units and have them counted for compliance with KP obligations
- Article 6, 12 and 17 which allowed
    - For the creation and transfer of unit in non-capped countries (non-Annex 1)

- The transfer of units under the cap, for countries that had budgets, that is an absolute cap

The 2015 agreement is just beginning to take shape through the papers that the co-chairs have put out, but there is still a long way to go before Paris. A discussion on FVA, NMM and NMA therefore requires some assumptions to underpin that discussion.

- There will be an international climate change agreement
- Through INDCs all Parties will have to contribute to combating the danger of climate change
- International transfers of mitigation outcomes will be recognized and sanctioned – a provision similar to Art 310- to 3.12 of KP
- Different types of mitigation instruments/approaches/market mechanisms will be available and used
    - Developed, created and operated COP (e.g. CDM, JI). So far they have been baseline and credit mechanisms
    - Created and operated by Parties (or not by the COP) – e.g. EU ETS, California ETS, China Pilot systems, JCM, VCS, Gold Standard). These could be cap-and-trade or baseline-and-credit.
- There will be different types of mitigation commitments under INDCs (this list is not meant to be exhaustive, it simply focuses on what is relevant to the topic at hand)
    - Economy-wide with absolute caps (not dissimilar to KP commitments, but without AAU budget)
    - Subnational level with absolute caps (e.g. sectors of the economy, subnational regions)
    - No absolute caps

International transfer today

Most of the international transfers to date have taken place in the context of the carbon markets that have evolved in the KP, or in efforts to address KP compliance. It could, however, be argued that some of the voluntary, non-compliance transactions have been driven by many factors, and where markets may not have been the sole driver in concluding a transaction. Some of the early REDD transactions would fall into this category, as would others in the voluntary market.

With the development of the California and Quebec ETS, and their link, we will start to see international transfers of units that are outside the KP. The same will be true when it comes to the JCM, which Japan is currently operationalizing. The link between Australia and the EU, which would have been a major event, was cancelled due to the political decision by the new Australian government not to pursue carbon pricing as an approach to mitigation.

As such, the world of international transfers of mitigation outcomes is rapidly changing to a much more heterogeneous one, from one where the CDM mechanisms (Art 17 for AAUs, CDM and JI) had a quasi-monopoly.

2. Framework for Various Approaches

FVA: Definition, Functions, Scope, and Governance

Definition

The FVA is a set of rules, components, standards and protocols that together make up a framework (FVA) to ensure that all internationally transferred mitigation units/outcomes used for international compliance (with obligations under the UNFCCC) maintain the environmental integrity of the global climate change agreement.

The FVA is not concerned with activities that are purely of a domestic nature, and do not lead to international transfers of units or outcomes. As such, for illustration purposes, any ETS that is strictly domestic, that is, does not export units that another jurisdiction will later use to comply with UNFCCC obligations, is not under the remit of the FVA.

Another way of looking at the FVA is to say that it will ensure that all units resulting from mitigation approaches that meet certain conditions, and that are transferred internationally, can be used, and counted, for international compliance with UNFCCC obligations. What those conditions are, and how the UNFCCC will test for them, are the topic of another discussion, as one of the functions of the FVA.

As mentioned above, as the 'orderly and Cartesian' world of the KP makes room for a more heterogeneous one, in order to maintain the integrity of the agreement there must be a framework that will provide a common approach on what to count, on how to count it, towards compliance.

There is a significant lesson that we must take from UNFCCC negotiations in general and from the history of the KP mechanisms. The temptation to burden the FVA with every provision that Parties wish to make risks turning the discussion into a version of the UNFCCC negotiations and must be resisted.

It must be understood that the FVA has an inclusiveness role. The FVA must not be confused with the **approaches** that it aims to integrate under the UNFCCC. The FVA does not produce any reductions itself, and as such, while demand is an important function of the level of ambition, it is not relevant to discuss it in the context of the FVA.

Functions

In order for the FVA to achieve the objectives outlined in the definition above it will need to fulfil at least some of the functions outlined below:

1. *Provide information for compliance accounting*. The accounting system will be central to the 2015 agreement and the FVA is the part of the agreement that is expected to provide the information that will ensure its functioning.

2. *Define protocols and mechanisms to avoid double-counting* at
    - Issuance
    - Compliance
3. Define rules to

a. *Identify what gets counted and under what conditions it gets counted*. That is, under what conditions do units/outcomes that are transferred internationally and used by a jurisdiction other than the one where they were produced get counted toward UNFCCC compliance

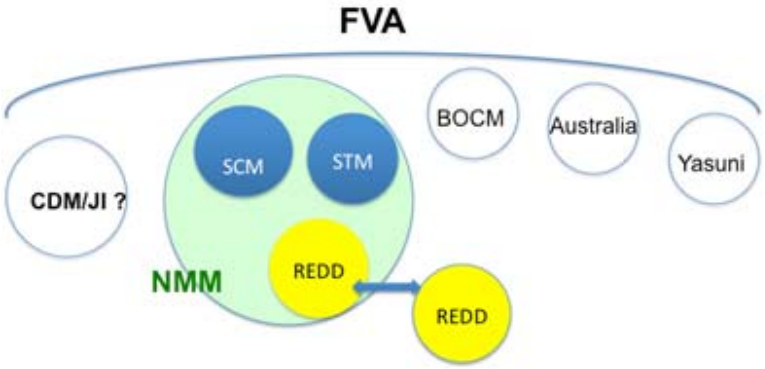
b. *Decide on the mitigation value assigned to outcomes/units issued*? In the KP, that value was assigned by the UNFCCC, as all units used for international compliance were issued centrally. In the case of the CDM, it was 1 if the project was deemed to be additional. In the new, decentralised and heterogeneous world that is no longer very clear, as units can now be issued by many jurisdictions. Different approaches have been discussed, including the concept of risk-adjusted value, which is somewhere between 1 and 0.

4. *Ensure that net mitigation is achieved*. This is not a well-understood concept that has been adopted in the UNFCCC language in the drive to move away from 'offsetting'. A distinction must be made between a 'baseline and credit' mechanism that produces mitigation outcomes (e.g. CDM), and offsetting, which is how the mitigation outcome is used. In the KP, it was used to offset reductions in Annex 1 Parties. Let's stay away for shortcuts.

Scope

It is generally accepted that the FVA is under the authority of the COP. It is important to fix the scope of the FVA, as this will also allow further definition of its elements and relationship with existing and future mitigation approaches. Figure 1, below, outlines the view that has been expressed by CEPS in previous submissions to the UNFCCC, starting in 2012. In this way the FVA can be seen as an 'umbrella' for all mitigation approaches that are transferred internationally.

Figure 1. Scope of the FVA



SCM – Sectoral Crediting Mechanism.
BOCM – Japan Bilateral Offset Mechanism.
STM – Sectoral Trading Mechanism.

In addition, it must be emphasised that the FVA will cover developed and developing countries. The FVA will also cover all mitigations approaches and all mechanisms, including cap and trade and baseline and credit, as well as any other mitigation approaches that may emerge in the future. In this way the FVA must be conceived as flexible and resilient, and able to adapt to new approaches that will undoubtedly emerge over time.

The current international transfer of mitigation units has been south-to-north (CDM), and east-to-west (JI and AAUs). It can be expected that there will be a flow of mitigation outcomes/units south-to-south, and north-to-south. There is a need to adjust and move away from conceptualizing flows only as those that aided offsetting under KP, and understand that FVA will need to be able to accommodate flows in many directions. While it is true that some of these flows may not happen right away, it is nevertheless important to ensure that these possibilities are covered in the design and operational specifications of the FVA.

Governance

A fundamental principle of the FVA should be that all activities that can be effectively regulated at a level other than the international one should be regulated at that level. Only those activities, which, if not regulated internationally, would affect the integrity of the international climate change regime, should be regulated internationally.

The FVA, like any other components of the UNFCCC, should operate under the authority of the COP. The wording from Doha is constructively ambiguous "considers that any such framework will be developed under the authority and guidance of the COP".

Given the scope and purpose outlined above, the FVA needs to be part of the post-2020 agreement, which is under the Convention**. As such, it is imperative that the FVA discussion also be integrated into the ADP track of negotiations.**

The notion of the FVA being under the Convention automatically brings with it the principles of the Convention, etc. This needs to be well understood and applied judiciously, and not in a doctrinaire fashion.

The FVA will have to assess only certain aspects of the institutional arrangements related to international mitigation transfers. We must remind ourselves that the FVA should only concern itself with units that cross international borders and address and regulate matters that need to be regulated internationally, in order to ensure environmental integrity, including maintaining an accurate and robust accounting system.

As such, the FVA will involve itself in ensuring that 'a ton is a ton' (MRV, issuance, etc.), but should not involve itself in decisions such as whether the allocation in a domestic cap and trade is made through auctioning or not. That is a decision that will not impact the international climate change regime.

Consequently, only certain aspects of various approaches will be regulated globally, with many, such as the default option, regulated nationally.

It can be expected that the following aspects may be part of **the international set of rules and governance**. It must be emphasized that this is not an exhaustive rule:

- Rules and mechanisms for tracking outcome transfers, which will help with compliance accounting. For illustration purposes, an ITL and consideration of a UN-run registry, available to those Parties that wish to make use of it, are some examples.
- Set conditions for international transfers to be accounted for international compliance. Under what condition are units transferred internationally recognized for UNFCCC compliance?
- Avoid double counting at usage
- Conditions for net reduction

Issues that will be **governed at the local level** may include

- Governance of mitigation approaches (e.g. EU ETS governance). Most of the rules for these mechanisms/approaches will be set at the local level. However, depending on the type of commitment that the Party makes, and type of mechanism, some rules will migrate to the global level.
- Avoid double counting at issuance. The local jurisdiction (e.g. national level) will be the one that will have the most information on mitigation activities in that jurisdiction. Local authorities are best placed to check issuance for all possible mechanisms that could coexist in a jurisdiction, such as a domestic ETS, domestic offsets, CDM, VCS, etc.

Accounting under the FVA

Following up on the CEPS submission of March 2013, in order to set up an accounting system for the international transfer of mitigation outcomes/unit, the fundamental principle that has to be observed is that of double-entry accounting, which currently also forms the basis of accounting under the KP (Articles 3.10 to 3.12).

Units received by a Party (receiving Party) through an international transfer are credited to that Party's registry, and can be counted at the end of the period for meeting compliance obligations.

On the other side of the ledger, the Party that transfers mitigation units (sending Party) will have units debited from its registry and its quantified emission reductions, if it has taken one.

To operationalise this simple concept two issues need to be resolved:

a. **What gets to be counted**? While the principle is simple, based on general accounting practices and has a precedent in the KP, what conditions determine what gets to be counted? Do the units produced, the systems that produce them, or the jurisdictions where they are created, have to meet certain conditions?
b. **How do we *determine (test) whether* conditions are met**? There are different options to address these issues. We must remember that we have classified approaches/mechanisms as UNFCCC/COP run and created, and as run by Parties, or non-UN bodies.

1. Outcomes/units from UN-run mechanisms/approaches. These units, the outcome of a UNFCCC run and certified process, and issued by the UNFCCC, must, axiomatically, be good for compliance with UNFCCC compliance. As such, there are no conditions attached to these units being counted for compliance.

2. Outcomes/units resulting from non-UNFCCC run mitigation approaches. In this case, two different approaches can be considered for adoption.

a) **Mechanism pre-qualification**. A first approach would be to consider the FVA as a set of standards/criteria, defined by the COP, which ensure the environmental integrity of what gets counted for compliance. This approach has been discussed in detail in the previous CEPS submissions to the UNFCCC on this topic.

In this scenario, **ANY and ALL** non-UNFCCC-run approaches/mechanisms that wish to have units, which circulate internationally, to be usable for compliance with UNFCCC obligations (and counted), must go through this qualification process.

This is not dissimilar to the current CDM approach, except that what gets qualified are mechanisms (ex-ante), and not the units that are issued by these mechanisms (which qualify ex post, such as in the case for the CDM).

This is could lead to a heavily centralised system, but is likely to be seen as having very strong environmental credibility.

At the same time, it is likely to be overly bureaucratic, with high transaction costs, if the CDM is any guide. Also important is the fact that it may also break the principle enunciated above, and unnecessarily act in cases where an intervention is not needed at the global level.

As discussed in previous CEPS submissions, the process for system qualification can range from a simple 'transparency approach' (through a declaration), to an 'approval' process (the system is tested against the standards by a central regulatory body).

b) **Party pre-qualification**. A second approach is to qualify sending Parties for international transfers, based on a set of criteria determined by the COP. In this case, Parties are assessed ex ante.

Depending on the type of commitment that the Party has undertaken, it may have to be subjected to an increased level of UNFCCC oversight to ensure that the environmental risk to the international system is minimised.

Parties that pre-qualify. If a Party meets a set of criteria, similar to those outlined for participation in Article 17 of the KP, the units that they 'export' would be deemed 'good

to be counted'. In this case no further international oversight would be required (apart from tracking) for the units sent internationally by that Party.

One way to explain this would be that the Party, having an absolute quantified commitment, takes the risk for the environmental value of the units/outcomes it exports.

This may be criticised as being similar to JI T1, and is highly dependent on all the Parties accepting the INDCs that are part of the 2015 agreement. The 'hot air' issue emerged not from the process itself, but from the questioning of the reduction causes in Parties with EIT. However, one could argue that this is also not dissimilar to the excess EUAs in the EU ETS, which are the result of a reduction in economic, and not from mitigation efforts.

Key criteria that a Party would have to meet to pre-qualify (for illustration purposes), may include:

- Is a Party to the 2015 agreement
- Has an quantified absolute emission reduction target
- Has in place an MRV system in line with UNFCCC specifications
- Has submitted a most recent inventory
- Etc.

Parties that do not pre-qualify. In the case of Parties that do not fulfil all the conditions set by the COP and outlined above, in order for units transferred internationally to be counted for UNFCCC compliance they would have to be subjected to international oversight.

This international oversight could be ex-ante (qualifying mechanisms) or ex-post (qualifying units issued, as was the case for the CDM).

The international oversight may be set at different levels, if some conditions, but not all, are met by a Party.

The oversight would occur in areas that impact environmental integrity such as baseline setting, accreditation of verifiers, MRV systems, additionality criteria, public participation, etc.

One important aspect of the Party pre-qualification approach is that it may provide incentives for Parties to take increasingly stringent commitments, which would provide them with an easier access to international carbon markets.

Tracking and double-counting

Tracking of units under the KP is currently done through the ITL, which 'knows' the whereabouts of every unit issued by the KP that is valid for compliance with KP obligations. That is made simpler because only units issued by the UNFCCC, with unique serial numbers, are good for compliance with the obligations under the KP.

Based on the assumptions made the situation will be radically different under the 2015 agreement. As such, while respecting the principle of doing what is possible at the local level, what are the components and protocols that are needed to ensure that we avoid double-counting, at issuance, and at usage for compliance?

Since a number of approaches can theoretically co-exist in any jurisdiction (CDM, VCS, NMM, domestic ETS), the local regulator is the most appropriate body to ensure that there is no double-counting at issuance. It will have to work with the various approaches in order to have access to the information that is needed to discharge that responsibility.

To ensure that there is no double-counting when units are used for compliance, the units transferred need to be tracked. This tracking is currently done though a central system that manages all transfers between national registries of KP Parties, the ITL. It is a system that has worked since the start of the KP.

However, it must be noted that transfers inside the EU ETS are managed by the EUTL (European Union Transaction Log). This ensured that what is essentially a domestic trading system (the EU ETS) is not subject to any restrictions or conditions at the UNFCCC level. However, the UNFCCC-run ITL also registers transfers between Parties to the KP.

The 2015 agreement could continue to use the same approach and maintain the ITL as the facility that will make the transfers and keep track of international transfers. This would be easy to rationalise because "if it isn't broken, don't fix it".

However, there is reluctance to allow a UNFCCC-run facility to have control over what are expected to be, in many cases, bilateral linkages between different countries/Parties.

Another approach that is proposed is that transfers be done at the bilateral level, and only netting (the net amount transferred between countries) be reported at the end of the year to the ITL.

This would ensure that transfers are done by the countries that are linked to each other, but that information that would prevent double-counting is available at the UNFCCC level.

In order to ensure that a market emerges, what is important is that the transfer system is reliable. This can be done with, or without, the ITL being a hub. However, it must also be also recognised that a linked system is only as strong as its weakest link, both in terms of reliability and security. This has led to an increasingly centralised system of national registries in the EU ETS. Increased cost could also be a factor, as different systems could link, but the further expansion of the system could be hindered by different standards that emerge in different clusters.

Transparency of information for regulation could be ensured, but with reduced effectiveness and efficiency, as ex post reporting formats, type of information, etc. may be different from system to system.

One final issue that merits a mention is that of national registries, which all Parties engaged in international transfers will need to have because units will no longer be issued exclusively in a centralised way, as it currently is the case under the KP.

Consideration should be given to the availability of a UNFCCC-run registry that would be available to those Parties that may not wish to develop and operate their own, and may wish to use this UNFCCC-run facility.

In the same spirit, use of the ITL or its successor as a transfer and tracking platform may also be made available to those Parties that wish to use this option, instead of operating their own facility.

Net Reduction

Net reduction is a term that has gained traction in the debate on carbon markets and carbon accounting, and was included in UNFCCC agreed texts in Doha and Warsaw.

However, we feel that this is not a term that has been defined or is well understood. There is certainly no common or agreed understanding among Parties and stakeholders on what the term means.

It is a reaction to offsetting, which is the way that units issued from CDM and JI are used in the KP. CDM is referred to as an offsetting mechanism. This is not only incorrect, but also misleading.

The CDM is a baseline and credit mechanism that has as output units reduced from a baseline (CERs), on a project–by-project basis. The way CERs are used under the KP are as offsets – one unit reduced in an Annex 1 country offsets one unit in an Annex 1 country.

As such offsetting refers not to the mechanisms but to the way in which units transferred are used.

As such, an alternative definition of net mitigation would be that units issued in one jurisdiction (especially from a baseline and credit mechanism in a jurisdiction that does not have an absolute cap) cannot be used as 'one-for-one' to offset emissions in another jurisdiction, which uses them for international compliance.

Different ways of producing net mitigation have been proposed. They focus on ensuring conservativeness in the definition of the baseline and issuing few units than would be the case in a business as usual (BAU) baseline.

While this is possible, we believe that this is not the best way forward. Calculation of crediting is an imprecise art that already has enough controversy and approximations associated with it. Since we can expect a large variety of mitigation approaches, getting the same degree of conservativeness in all these approaches will only lead to further controversy, as well as an additional level of imprecision, piled upon the already existing one.

In addition, mitigation units or outcomes will be produced, but an initial lack of clarity is likely about whether they will be used for domestic or export purposes.

As such, a better route is to use the best estimation possible for the crediting of mitigation efforts. In order to achieve net mitigation, a discount should be put in place at usage for compliance, depending on who uses these credits for compliance – if it is the Party that has produced them, then there is no discount; if it another Party, then a discount will apply.

3. New Market Mechanism

The NMM has been created and there is an expectation that modalities and procedures will be produced through the SBSTA process.

It is unclear what the NMM really is, but the consensus seems to emerge that the NMM are mechanisms that are operated by the UNFCCC. The existing CDM and JI would fall in that category.

In our view, the NMM may have more than one window, such as a project and a sectoral baseline and credit approach. It may also have a REDD+ mechanisms window.

The purpose of the NMM would be to be available to those Parties that wish to use them in their jurisdiction. They may wish to use the NMM windows for a variety of reasons, including not wishing to develop their own, not having the capacity to develop and operate their own or, the desire of off takers of the mitigation outcome to have them result from a UNFCCC instrument, which they may see as having high integrity.

It is clear that the best and simplest option is for the use of the NMM to be on a voluntary basis, while being available to all Parties that sign the 2015 agreement.

The Modalities and Procedures (M&P) for NMM may have to be at two levels: a fairly high-level set of M&P that will provide the general governance and process, and a much more detailed level, such as that provided by the Marrakech Accords for the CDM.

The CDM, as well as JI, have accumulated much experience and knowledge in recent years. This cannot go to waste and needs to be incorporated into the new 2015 agreement and put to good use. In the end the CDM is a process to produce and issue credits from a project-by-project baseline and credit approach. Such an approach will need to be in the 2015 agreement for those Parties that wish to use it.

As such, the best outcome would be that post-2020, an International Crediting Mechanism be incorporated in the NMM, with a project-by-project window, and a sectoral window.

The CDM, and all its M&P, improved and simplified where agreed by Parties, should migrate to the NMM and be merged into that new instrument.

Whether other windows, or approaches operated by the COP, need to be developed with their M&P, is something that will emerge over time and will depend on the demand for such approaches, and on the agreement that Parties to the Paris agreement can reach.