Call for Inputs on the New Market Mechanism
September 2014

IETA proposes a transformational shift to accelerate public and private sector action through a global carbon market, which collectively can help meet the 2°C temperature limitation goal. By facilitating linkage between emission reduction approaches under a dedicated FVA transfer system, Parties will be able to cooperate in the development and growth of existing and new market approaches through the New Market Mechanism (NMM). This approach will catalyse investment and ensure environmental integrity through accounting and reporting - and will enable Parties to meet their Contributions together in ways that accelerate economic growth and avoid competitive distortions.

The New Market Mechanism (NMM): IETA's views on the mechanism. We have responded to each element listed in FCCC/SBSTA/2014/L.12/Art. 6 (A through F).

Introduction

IETA has filed multiple submissions on the NMM and its sister-topic, the Framework for Various Approaches (FVA), over the past four years. We have observed international negotiations on these topics, and have participated in numerous expert forums. This year, we are informed by new academic research conducted by the Harvard Project on Climate Agreements, which has helped us re-think the kind of international policy architecture needed for a world of "bottom up" action.

To that end, the recent growth of interest in carbon pricing in many jurisdictions has myriad implications and benefits for the New Market Mechanism discussion. Subnational markets have emerged in the U.S. (California, RGGI) and China (seven pilots), and new national programs are in the design phase throughout the world. International negotiations, however, appear stalled on the topic of national market infrastructure as Parties and Observers alike attempt to make sense of a complex set of overlapping discussions across the NMM, FVA, NMA, CDM Reform, MRV and Reporting agendas – not to mention new accounting and reporting discussions under the ADP.

IETA therefore proposes a set of specific recommendations aimed as consolidating and simplifying the market-related aspects of negotiations. These points are built on our prior submissions, those of others and the international negotiations on these topics – and on lessons from discussions with many Parties.

A) The New Market Mechanism: Design and Governance

We believe that the design of the NMM should become narrowly focused on **two simple functions**:

1. Providing access to a **central, harmonized transfer mechanism** for Parties interested in linking their systems; and

2. Enabling **transfers of mitigation units produced by a new Unified Project Crediting Mechanism** (UPCM) created within the FVA[1].

Our vision is that the UPCM should unify the previous NMM and CDM-reform agendas. It should be established to produce a **common project-based unit** by recognizing achievements against standardized sectoral performance benchmarks. These could obviate the need for a traditional additionality determination, which would simplify and standardize the project review and approval process. The very useful discussions in the NMM negotiations about improved crediting arrangements for sectors should be consolidated with the CDM reform discussions into a new UPCM, which should be developed on an accelerated timeframe. Our vision for the UPCM is more fully described in our FVA submission.

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[1] It is possible that the UPCM could evolve from a consolidation of the NMM and CDM Reform negotiations in an accelerated dialogue convened under the NMM. But we assume in this submission that the stalled processes in the NMM and CDM negotiating tracks may call for consolidation in a different track, which we suggest could be the FVA.

This basic NMM would need little additional governance beyond simple accounting rules. Nations that used the NMM for transferring or receiving units, whether from other Parties or the UPCM, would report transfers and receipts as part of their national reports. Transfers and receipts would be tracked under the FVA through national registries and the ITL, which would function primarily at the end of compliance periods and during the reconciliation (or "true up") of accounts. **Th**e COP could review progress of the NMM's operation, including the policy structures utilizing it, as part of its on-going oversight of the FVA.

Finally, we see merit in the longstanding discussion of mobilizing greater reductions through sectoral crediting. We prefer an approach that assesses projects against a sectoral benchmark. This blend of project assessments against sectoral benchmarks could attract private investment more effectively than a model where credits are produced at a sectoral level. We recommend that this approach be advanced through the UPCM.

B) The New Market Mechanism's modalities and procedures;

A simplified NMM would undergird transfers in the FVA. The remainder of the operational rules and modalities for interconnected national systems or pools would be contained in bilateral or multilateral cooperation agreements between and amongst Parties. We would urge Parties to develop these rules and modalities in consultation with stakeholders – and ultimately to make them publicly available.

C) Its relationship with the framework for various approaches and the mechanisms under the Kyoto Protocol;

Our vision for design of the New Market Mechanism is that it should become the international transfer mechanism for Parties interested in building a common international carbon market.

The trading structure within the Kyoto Protocol illustrates the part played by the market mechanism. Within its design, the unit of account is the Assigned Amount Unit (AAU). The emissions trading provision in Article 17 enables transfers of units. The AAU establishes the need for trade and creates basic supply and demand through the allocation process against national targets relative to actual emissions. This gives value to the AAU, which in turn creates demand and value for CERs under the Clean Development Mechanism (CDM). Without the unit-based accounting and supply/demand balance created by AAU accounts, the CER and similar instruments would have no value and could not exist in a meaningful sense.

Therefore we believe the primary function of the NMM would be to enable transfers of carbon accounting units generated by domestic mitigation approaches undertaken by each individual Party as well as units produced by the UPCM.

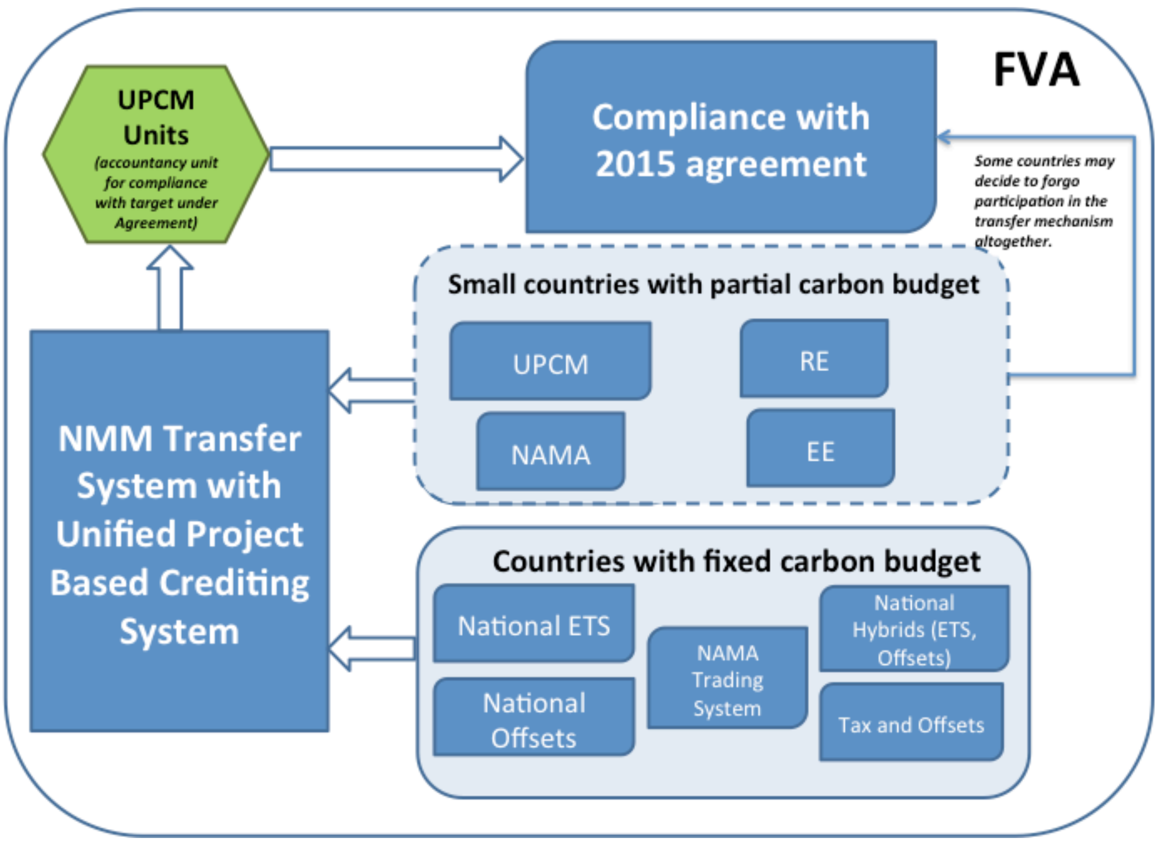

Figure 1: The Relationship of the NMM within the FVA
(Note: UPCM-Unified Project-based Crediting Mechanism)

The NMM will operate in a world of bottom up pledges, nationally designed trading systems and NAMAs – which are in essence a series of various approaches operating

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within a common framework (the FVA). The NMM should become the exchange function for all of the tradable commodities. The private sector would gain confidence from this strong basis for trading.

A major issue on the horizon is how to enable new markets to develop in a way that enhances their compatibility with other systems – which we believe will be a pre-condition to linking agreements. Our vision of ensuring this compatibility is to do so not with prescriptive eligibility requirements, but rather with market infrastructure tools made available within the FVA. These tools could include components of emissions trading systems, such as—

- Monitoring and verification protocols for key sectors;
- Standardized emission performance benchmarks for key sectors;
- Standardized unit issuance procedures;
- A registry and unit issuance system to establish ownership of emission reduction units;
- A standardized reporting template; and
- An accreditation system for independent verifiers.

A Party's ability to utilize these elements of infrastructure could enhance their ability to develop high quality systems.

<u>Key steps to participation in the NMM under the FVA</u>

a) National governments begin (or continue) the task of designing policy measures to manage emissions in their own economies, but with the specific goal of a tangible national contribution to the global goal (e.g 2°C).
b) National governments access key elements of international architecture (sectoral benchmarks, issuance procedures, registry, etc) with assistance from the UNFCCC secretariat.
c) Industry sectors affected by such policy measures look for the flexibility to manage emissions more widely and in particular seek access to reduction opportunities outside their national borders. This can only be realized through some form of international trading.
d) A national government seeks linking agreements through separate bilateral or pluri-lateral agreements that benefit from the NMM.

e) The national government recognizes any flow to and from its registry and include "transfer and receipt" totals in periodic reconciliation included in its the international Contribution report.

C) The New Market Mechanism: The meaning of "a net decrease and/or avoidance of global greenhouse gas emissions";

The "net mitigation" topic would be taken up in the design of the FVA and the UPCM. This simplified NMM would not, in and of itself, create additional impacts on this topic.

In brief – and as described above and in our FVA submission – we believe the mitigation levels could be assured in strong **performance benchmarks** for key sectors. A Party could use these benchmarks to establish allocations in a cap and trade system – or to measure reductions within a national offsets program or the UPCM. If there are uncertainty bands around measuring performance in certain sectors, the Parties could adopt mechanisms for addressing them with targeted techniques, such as the "buffer" reserves used in the CCS and REDD+ contexts.

D) The New Market Mechanism: Lessons learned from the mechanisms under the Kyoto Protocol;

The Kyoto Protocol's flexibility mechanisms have raised more funds (+ $315 billion) for climate mitigation in developing countries than any other climate policy to date. There are, however, some lessons from the Kyoto Mechanism that should be reflected upon during the design phase of the NMM.

Mitigation approaches should represent real, sustainable and permanent reductions, and be subject to robust monitoring, reporting and verification. Unit-based accounting could ensure that one tonne of reductions located in 'Party A' could represent one tonne of reductions recognized for compliance in 'Party B's' system. Mitigation approaches should be based on robust standards to enable linking and harmonization--including the development of standards that anticipates the needs of emerging market-based mechanisms. Common standards and market frameworks are critical components for establishing a truly global carbon market, because they make systems easier to link in the future. The production of a fungible unit that is broadly accepted for compliance provided an added incentive for investment.

To function efficiently, the NMM should do what it can to avoid regional or national distortions, e.g. arising from unilateral bans on credits from CDM-projects in certain countries or certain types of projects as a result of lack of confidence in the environmental integrity of methodologies and governance; it should aim to keep administrative arrangements as transparent and efficient as possible whilst maintaining adequate quality control to safeguard the system's integrity.

Any market-mechanism is dependent on the private sector for its success. Private sector operators and investors must be convinced there will be a market for the NMM: confidence can be increased by clear decisions at the UNFCCC and within Parties about the level of emissions reduction ambition, as well as a continued political goodwill towards the project-based mechanisms (a reformed CDM/JI). The private sector can mobilize considerable amounts of finance for mitigation activities as long as the risk-reward ratio is acceptable and a sufficient timeline that justifies the required capacity building.

The CDM has been instrumental in achieving a new level of engagement and communication between the UN system and the private sector and civil society, and it has introduced many important elements of national systems, such as participation rights, due process and transparency into the UN context. However, a future UPCM should not continue with a project-by-project additionality test. It would be better to assess projects against a set of straightforward sectoral benchmarks. We also envision a simplified crediting approach, perhaps through positive lists, to encourage smaller-scale projects that could play an important part in expanding energy access in developing countries. The CDM's approach to project-specific additionality testing is not feasible for scaled-up approaches.

The CDM has been a powerful instrument for developing processes and standards, setting up institutions, building capacity and enhancing dialogue between different actors engaged in mitigation activities. It can grow even stronger in a consolidated UPCM that is widely accepted for compliance. It will continue to be a relevant instrument for identifying and incentivizing cost-effective mitigation action in a broad range of contexts and countries, wherever sectors are not covered by economy or sector-wide mitigation policies (such as emissions trading systems) and/or gaps exist in other climate policy instruments.

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