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SUBMISSION BY ITALY AND THE EUROPEAN COMMISSION ON BEHALF OF THE EUROPEAN UNION AND ITS MEMBER STATES

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

Rome, 29 September 2014

Subject: Design and operation of the new market-based mechanism

Introductory Remarks

1. We welcome the opportunity to express our views on the further development of the New Market Mechanism (NMM), and, have some general observations on provision for markets mechanism(s) and market related accounting in the 2015 agreement which guide our attitude and approach to the issues raised.

2. Carbon market instruments are a useful tool which facilitate enhanced mitigation action by increasing flexibility and reducing the costs of achieving a given mitigation outcome, and by engaging private finance investment and expertise in necessary innovation.

3. Domestic policy measures and choices including the implementation of domestic carbon markets, and decisions by countries to link domestic carbon markets internationally are a matter of national responsibility and discretion. The role of the UN should be focused on facilitating international cooperation on combatting climate change including through use of markets.

4. Many countries are already establishing domestic carbon markets aimed at delivering domestic emission reductions. This is set to continue, and we believe that once established countries will move to link their domestic measures to maximise their effectiveness.

5. Alongside carbon market instruments established at domestic level, Countries may also choose to rely to on internationally defined market instruments as the route for participation in markets, as a supplement to, or instead of, domestic market measures.

6. Against this background the international community can facilitate international cooperation on markets in the 2015 agreement in two distinct ways;

a. by providing for market related accounting rules to enable eligible parties to count the results of international trading of mitigation outcomes between domestic carbon market instruments towards quantified commitments, and

b. by providing for one or more UNFCCC market based mechanism(s) for the certification of mitigation outcomes applicable particularly where a party is not otherwise eligible to participate in international markets under market related accounting rules.

7. Market related accounting rules, the subject of our submission on the Framework for Various Approaches (FVA), should provide a clear and unambiguous route for parties *to count* the results of international trading towards their international commitments; this framework must ensure that these commitments are not undermined for example through double counting or double claiming of emission reductions.

8. A market mechanism, the subject matter of this submission on the New Market Mechanism, should provide a clear and independent route for the UN *certification* of mitigation outcomes for international use towards commitments. This mechanism supplements accounting provisions by providing an alternative route for participation by Parties. It may be the only route in respect of activities outside the scope of relevant commitments, or where a party cannot otherwise participate in an international market because they do not fulfil the full accounting eligibility requirements.

9. We do not envisage units derived from a new mechanism being used for compliance purposes before 2020. This places its use firmly in the post 2020 context. We believe therefore that further discussion on the NMM could contribute to the work of the ADP by providing space to elaborate provision for use of a mechanism under that agreement. Nevertheless, experience gained through pilot activities before 2020 could facilitate the development of the technical details of the modalities and procedures for a Market Mechanism and also build market readiness and institutional capacity in prospective implementing Parties.

A New Market Mechanism

10. The new market mechanism represents an opportunity to consider the potential design of provision on market mechanisms, one that fits with the new international context where all parties will be making or are expected to make contributions to mitigation.

11. At the core of this is the understanding that in future all Parties have a general interest in ensuring that contributions to mitigation, whether in the form of a commitment or otherwise, are reflected in the international use of markets. When considering a market mechanism in particular this will require that the concept of "net mitigation" is firmly embedded in the design.

12. This could be achieved in a variety of ways which need further discussion, but at a minimum should ensure that international commitments and domestic policies of the host party impacting mitigation are appropriately reflected in the crediting thresholds established for the crediting of mitigation outcomes (Crediting Thresholds) under a mechanism. In this context too it may also be appropriate to set crediting thresholds using a benchmarking approach so as to reflect the mitigation potential of the activities covered rather than setting them on the basis of historic or projected emission levels alone.

13. Under such a system only mitigation outcomes achieved beyond predetermined crediting thresholds could be credited for use by another party, and therefore towards count towards that party's commitment. As a result, mitigation outcomes achieved up to these thresholds could either be retained by the host party to count towards its commitments – as an explicit own contribution, or in default to accrue to the benefit of the atmosphere, i.e. count towards neither the host nor the acquiring parties commitments. In our view it will be essential to ensure that the net mitigation so delivered is measured and verified to ensure robust and transparent accounting and ensure avoidance of double counting.

Lessons learned from existing mechanisms.

14. The Kyoto Protocol has provided us with a wealth of practical experience with regard to the design and implementation of centralised mechanisms such as CDM and JI. The CDM with its broad coverage and diversity of activities and host parties offers perhaps the most obvious model upon which to consider lessons learned. The final report of the High Level Panel on the CDM Policy Dialogue, and associated research (see: http://www.cdmpolicydialogue.org) provides a comprehensive assessment of the CDM. While here we limit ourselves to presenting some lessons learnt from Kyoto Mechanisms there may be value in looking to the experience in all relevant carbon markets at regional national and subnational level, and from other non-carbon related international regimes as well.

15. The CDM and JI track 2 has demonstrated the benefits for participants and stakeholders of a commonly defined and supervised mechanism in terms of the relative simplicity, transparency, reliability, and rigour of a unified approach to the assessment of emission reduction activities and the generation of emission reduction credits. A fragmented landscape of multiple uncoordinated national offset systems cannot be expected to deliver all of these benefits to the same standard, and the problems of the CDM and JI might well be multiplied in a range of unregulated various approaches.

16. The CDM and JI, driven in large part by EU led demand for international credits, established for the first time an international market price for greenhouse gas emissions, providing an incentive to find, implement and quantify cost-effective mitigation outcomes across a broad range of sectors, countries and stakeholders. Amongst other achievements the CDM and JI have;

- **Provided an international standard and reference for the assessment of emission reductions** Both CDM and JI have established and revised a tailored governance structure; the institutions and procedures for assessment of emission reductions, as well as elaborating principles and implementing detailed standards for determining and quantifying additional mitigation outcomes, both at project and programme level,
- **Leveraged Significant Private Sector Investment -** hundreds of billions of US dollars, mainly from the private sector, for projects and programmes that have generated 1.5 billion tonnes from CDM and 850m tonnes from JI.
- **Contributed to technology transfer and sustainable development** co-benefits in the host countries.
- **Raised awareness of mitigation opportunities** through an extensive open database of more than 200 methodologies and over 8 000 real-life projects and programmes under CDM and 600 under JI.

17. The CDM and JI, the future of which has yet to be determined, has also illustrated several issues that need to be considered and might be addressed in the design of future mechanisms provision, including through adoption of alternative approach to setting crediting thresholds:

- **Concerns over environmental integrity of certain units issued under these mechanisms**. A continuing controversy under both the existing crediting mechanisms remains ensuring the consistency and objectivity of the assessment of additionality which we view as a test to ensure that individual activities are not "business as usual".

- The inherent difficulty with an approach focused on assessing whether an activity is additional to a counterfactual baseline could be addressed, at least in part, through adopting a different approach to setting thresholds, including through use of performance standards (i.e. benchmarks) where thresholds for crediting are fixed below BAU. Such an approach could also provide an alternative to additionality assessment and should be explored further.
- **Lack of systematic approach to reflecting national policies in baselines**; The current practice in setting reference levels for emissions and crediting thresholds under the CDM, makes no provision for the host party to identify an explicit contribution to mitigation, or for such a contribution to be clearly reflected and accounted for in the mechanism. In addition, significant policy developments with an impact on emissions are systematically ignored, and the potentials and costs of action in different sectors are not systematically or consistently considered, even to the point of creating perverse incentives.
- **Uneven distribution of registered activities across technologies, sectors and host countries;** There are a variety of explanations for the distribution of activities across the CDM, many of them unrelated to the design of the mechanisms and related rather to national circumstances and capacities which cannot be address in mechanism design alone. The CDM has however also demonstrated the challenges of an undifferentiated approach setting crediting thresholds for emissions reductions; onewhich fails to take into account of relative mitigation potential and costs of mitigation in different activities. Some Parties and sectors have benefited significantly in respect of a relative small number of activities where emission reduction potential is high, costs of abatement are low, and capacity is large, while other parties and sectors with lower potential, higher costs and capacity have not.

Design and Governance

18. In deciding the design and governance of the mechanism it is important to recall key features and potential elements or characteristics we have already agreed, particularly in *Para 79 of Decision 2/CP.17 and Para 51 of Decision 1/CP18.* We have already commented on these characteristics and elements in two submission: in our submission of 19th March 2013 on possible elements of the mechanism agreed in para 51 of the Doha Decision; and we addressed questions with respect to the design of the NMM identified at SBSTA 39 in our submission of 12 September 2013.

19. The design and governance of such a commonly defined mechanism(s) should build on previous experience, where the terms of participation are defined on the basis of proposals from parties, applying pre-agreed principles, standards and approaches and methodologiesfor monitoring and setting thresholds, and where proposals are subjected to a system of review and approval under the supervision of a board or committee.

20. In this context we could envisage that the mechanism might entail flexibility by providing multiple windows for participation according to context, for example, the nature and scope of the commitment of the party seeking certification of outcomes, national circumstances, and/or scale of action proposed.

Elaboration of elements of modalities and procedures

21. We have laid out a potential basis for modalities and procedures for a new market mechanism in our submission of the 12th September 2012, on the basis that any modalities and procedures would need to elaborate process and governance for the mechanism as well as minimum standards and eligibility requirements for activities and participants.

22. In summary, we think key elements of the modalities and procedures would need to reflect the following:

<u>A. The voluntary nature of the Mechanisms</u>: Participation in the mechanism would be voluntary and on the basis of a request by a party.

B. <u>Key principles on scope of participation</u>: The scope of participation could be defined in relation to IPCC classes and in any event avoid the potential for significant leakage.

<u>C. The process for defining participation in the mechanism</u>: In its request, a party would indicate:

a. the scope of its participation;
b. reference levels for emissions and thresholds for crediting within the indicated scope;
c. a justification of how these reference and threshold levels is consistent with any contribution, commitment, and other relevant national policies;
d. a description of the methodological approach to quantifying mitigation outcomes against the reference level and crediting threshold and how it meets relevant standards;
e. a clear statement of the level of net mitigation to be expected in respect of the indicated reference emissions, and arrangements for the distribution of emission reductions following review.

D. The approach taken to promotion of sustainable development including:

- Processes in place to ensure implementation of the market mechanism contributes to sustainable development
- Reporting on the contribution of the market mechanisms to safe and sustainable development

E. The approach taken to setting reference levels for emissions and crediting thresholds:

- Parties would define reference levels for emissions and crediting thresholds within a defined scope for a defined period and include reference to the mitigation potential of sectors.
- Key principles on setting reference levels for emissions and crediting thresholds: The period for reference levels would coincide with the period of any nationally determined commitment.

- Role of standards and methodologies in the Mechanism: Proposed scope and reference levels and crediting thresholds would need to be consistent with approved methodologies and where applicable ambitious performance standards (i.e. benchmark).

F. Approach taken to review of proposals: Requests would be reviewed by independent review teams to establish whether the scope and emission levels were adequately described and calculated in accordance with guidelines and standards to be elaborated.

G. The approach taken to the certification and issuance of units: Following international review and approval, units could be issued where emissions are demonstrated to have fallen below the approved crediting threshold.

The meaning of net decrease and/or avoidance of greenhouse gas emissions

23. The agreed concept of net decrease and/or avoidance of greenhouse gas emissions ("net mitigation") will need to be further defined and elaborated. We think that the concept could be interpreted and applied in various ways depending on the context and approach in question. There is some literature examining the concept and we believe this and the elements identified below could form the basis for its further elaboration.

24. In considering the incorporation of net mitigation in the NMM we think it is important to consider the following elements.

- Moving beyond Offsetting Net mitigation is commonly understood to mean going beyond offsetting. The current mechanisms are currently used as offsetting mechanisms to the extent that mitigation outcomes achieved in one party under a mechanism (i) do not explicitly incorporate contribution or net reduction, and (ii) are used to offset an equivalent increase in emissions in another party. This results in no net decrease in emissions overall. For instance, a CDM credit used by and acquiring party enables each decrease in emissions in the generating party to be balanced "offset" by an increase in emissions in the acquiring party.

- Net Mitigation as Own Contribution - Net mitigation can derive from an own contribution to mitigation by a host party. This net mitigation as own contribution requires that a proportion of the mitigation outcome associated with an international market activity is counted by the generating "host" party towards its mitigation contribution and, as a result, is not made available to other "acquiring" parties to allow them to increase their emissions.

- Net Mitigation as Net Atmospheric Benefit - Net mitigation can also derive from mitigation action that is not counted towards the mitigation of any party but occurs "on top" of the contribution or commitment of any parties. Net mitigation as “Net Atmospheric Benefit” requires that a proportion of the mitigation outcome associated with an international market activity accrues to the atmosphere – this means that a part of emissions reductions achieved in a credited activity or sector are not credited or used towards compliance by any party.

25. In terms of broad accounting principles we think these elements would suggest that:

- Offsetting: Only the proportion of the mitigation outcome beyond the crediting threshold would be credited and could be used towards the nationally determined commitment of another party. As a result net contribution to mitigation could be reflected in accounting terms in the following ways:

- Own Contribution: The proportion of the mitigation outcome not credited (those between the reference level and the crediting threshold) would contribute to delivering the nationally determined commitment of the party in which the reduction occurred (an *own contribution)*; this would only happen where there is a commitment covering the scope of the mitigation outcome;

- Net Atmospheric benefit: The proportion of the mitigation outcome is either not credited (between the reference level and the crediting threshold), or is cancelled, and therefore is not counted towards a commitment of any party but rather accrues to the benefit of the atmosphere *as a net atmospheric benefit*; this could happen where the mitigation outcome is not within the scope of a commitment.

26. We believe that the rules for the mechanism and related accounting should be structured in a way that reflects these elements in order to ensure that to net mitigation is incorporated in the NMM in a transparent and measurable way:

27. In terms of setting reference levels and crediting thresholds under a mechanism, this approach to crediting would mean:

- Crediting thresholds should be set in a manner that reflects the impact of existing and proposed national policy on emissions so only mitigation outcomes beyond those arising from the policy should be credited. It should not assume that the impact of national policies should be credited (noting that this would require a clear assessment of policy impacts for each sector covered by the mechanism);

- Crediting Thresholds for emissions reduction calculation should be based on objective criteria, i.e. ambitious performance standards where applicable and set below expected emissions, and therefore incorporate a net contribution to emission reductions, which could accrue to the host country, or to the atmosphere.

28. In terms of operationalizing this principle, parties would need to justify and determine reference levels and crediting thresholds in accordance with methodologies and with reference to:

- Nationally determined contributions, identifying clearly the contribution of the relevant sector to the nationally determined contribution;

- An ambitious assessment of emissions reduction potential in the relevant sector based on:
  - the performance of best available technology and optimum deployment of that technology;
  - A conservative estimation of the lifetime of technology and practices driving current and historic levels of emissions.

Relationship to the framework for various approaches

29. As already alluded to, we see the FVA as a potential building block for the accounting of international transfers between parties satisfying eligibility requirements, with clearly defined and quantified commitments. Against this background:

- The FVA's focus should be on what is needed to enable parties to count the results of international transfers towards commitments while avoiding double counting; market accounting rules, whereas

- The NMM's focus needs to be on what is needed to certify a mitigation outcome for use towards international commitments where a party cannot otherwise participate in the market, because it has not fully implemented (is not eligible under) broader market accounting rules.

- Where the FVA evolves into an accounting framework governing additions and subtractions of mitigation outcomes, as we think it should, the NMM would be fit within this framework, where the FVA provides for additions and subtraction to and from commitments of mitigation outcomes certified under the NMM;

We think the relationship between the two could be ultimately clarified through fixing minimum eligibility requirements both for accounting and for participation in the mechanism (see the FVA submission).

Relationship to enhanced mitigation action

30. As previously stated, we view market instruments as a tool to achieve and enhance mitigation. We recognise that any mechanism will only be used in conditions that parties generate significant demand for international credits. Rather fixing an approach to reference levels crediting thresholds and net mitigation, including ambitious performance standards will hard wire ambition in the use of mechanisms, and ensure that mechanism might only operate in circumstances that enhanced mitigation ambition is reflected in the mechanisms itself.

Conclusion

31. We look forward to the requested technical paper on the design and operation of the mechanism which should reflect on the issues referred to in para 6 of SBSTA 40 conclusions, and on the views of parties on these issues as expressed in submissions. We have also referred to other sources we believe should be considered in this reflection. We also refer to our previous submissions on the NMM, as well as to the separate submission on the FVA in this regard.

Previous Submissions

September 2013	http://unfccc.int/files/documentation/submissions_from_parties/application/pdf/nmm_lithuania_12092013.pdf	
May 2013	http://unfccc.int/resource/docs/2013/sbsta/eng/misc11.pdf	
November 2012	http://unfccc.int/resource/docs/2012/awglca15/eng/misc06a06.pdf	

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Generate Net Mitigation Effects in carbon market mechanisms. Energy Policy 68, pp.$413–422, 2014.

Vrolijk, Phillips 2013. Net mitigation through the CDM
Net Mitigation through the CDM A report for the Swedish Energy Agency available at http://www.energimyndigheten.se/Global/Internationellt/Net%20mitigation%20through%20the%20CDM.pdf

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