CARBON MARKET FORUM

CEPS

Thinking ahead for Europe

Submission to the UNFCCC on FVA and NMM

This submission draws on discussions that took place in the Carbon Market Forum (CMF) at CEPS. The CMF provides a neutral space where policy-makers and regulators are able to meet carbon market participants and other stakeholders to discuss carbon market regulation and general policy issues. The contents of this report reflect the general tone and direction of discussions on specific topics within the CMF, but its findings do not necessarily represent a full common position agreed by all the participants in the CMF, nor do they necessarily represent the views of the institutions to which the participants belong.

Executive Summary

The submission is premised on a post-2020 international climate change agreement under the UNFCCC, where there are pledges/commitments, as well as some form of end of period compliance. It also assumes that the UNFCCC has a say in the instruments used for compliance with this post-2020 agreement.

There is no single solution on how to provide a framework for the many domestic mitigation actions that are emerging around the world. As such, the functions and the overall architecture and flow are indicative, but some steps could be eliminated, or amalgamated, in order to simplify the process. This paper, is, and must be seen, as an options paper and can be adapted to different outcomes of the negotiations on the post-2020 agreement.

The Framework for Various Approaches (FVA) is a set of components and rules that will ensure that all approaches used for mitigation will meet certain standards, especially from an environmental integrity point of view.

The FVA will only cover mitigation actions, which produce units that are used for compliance with international obligations by a jurisdiction other than the one where they were created, or issued. These Approaches can be market or non-market based.

The FVA will be needed not only to create a liquid global carbon market, but also to allow some of the emerging national carbon markets to function properly. The FVA is therefore not a luxury, but a necessity.

The New Market Mechanisms will be mechanisms that will be designed, created and operated under the authority of the COP.

The FVA will allow domestic mitigation actions to link to the FVA and ensure that the units created can be used for UNFCCC compliance obligations, by following a number of optional tracks, including a Reporting & Transparency Track, at the discretion of each Party.

We recommend a step-by-step approach, which would recognize that only part of the elements of the FVA could be developed ahead of the 2020 agreement, through a Pilot Phase.

The Pilot Phase should start at COP 19 with the implementation of Transparency and Reporting part of the FVA. This phase will pilot the FVA, and not the domestic mitigation approaches, which are being implemented, independently of international developments, at the domestic level.

A Pilot Phase of the NMM should also be developed. The need and applicability of other provisions of the FVA will be considered after the completion of negotiations of the post-2020 agreements, in a second phase.

1. Background

Following the Copenhagen, Cancun, Durban and Doha Conference of the Parties (COP) meetings, it is becoming clear that we are moving towards a new climate change regime that in many ways will be very different from the Kyoto Protocol (KP) world in which we have been operating in recent years. This new climate change regime will play an important role in how a global carbon market may emerge and operate.

The new world will likely be more fragmented, but, at the same time, may provide the advantage of being more adaptable to national circumstances. It could also prove more able to catalyse new ideas, at the regional, national or sub-national level.

The concepts and proposals in this submission can apply equally to all mitigation approaches, be they market based and non-market based. To simplify the discussion, we will refer to markets only.

The Cancun and Durban agreements point to a world where many initiatives are emerging, and where all countries are contributing to combating climate change under UNFCCC principles.

In the KP architecture, in the areas of markets, there was a one-way flow, with developing countries producing reductions for export in developed countries. While it is unclear what the new post-2020 agreement will look like, it is likely that the flow of reduction units will stop being unidirectional, that is developing to developed country, and must be envisaged as developing- to –developed, developing to developing and even developed-to-developing as well.

One of the key issues discussed in Durban at COP 17, followed by more discussions in Doha, was the definition of new approaches to help match the higher level of ambition and recognize the realities of the new world. The New Market Mechanism (NMM) and Various Approaches have become the new buzzwords.

While not much substantive progress was made in Doha on these topics, the Doha COP provided a mandate for the SBSTA to continue with work programs on developing Modalities and Procedures for the New Market Mechanisms and further explore the Framework for Various Approaches. There will be, no doubt, many interpretations of the mandate, but one could simplistically translate the Doha mandate as

- To produce M&P for UN defined, approved and operated market mechanisms, which will stimulate mitigation actions across broad sectors of the economy, and may be project specific, or sectoral, in nature. This is somewhat surprising as there already are UN market mechanisms that operate on project-by-project basis (CDM and JI). It must be concluded that some Parties wish to continue to explore an organic link between the existing KP project mechanism and the broader sector approaches. Indeed, some feel that the existing CDM could be expanded and/or merged into the NMM.
- To "elaborate" on a UNFCCC Framework that would ensure that the rapidly emerging domestic mitigation approaches in different jurisdictions deliver real, permanent, additional and verified emissions reductions. If we are "elaborating" then we have already decided that it has been created, we are now discussing "how" and not "if" we create such a Framework. There has been little substantive discussion and convergence on how this can be achieved. One important area of convergence seems to be that such a Framework will only apply to reductions/units that emerge from domestically created mitigation approaches AND which will be transferred across national boundaries, to be used for compliance with international obligations under the UNFCCC. Pure domestic approaches that produce units used to meet any domestic compliance are not within the scope of the Framework.

During negotiations, Parties have expressed the view that any new work should also:

a) Minimise unnecessary international regulatory intervention in domestic mitigation action

b) Ensure a strong environmental integrity and contribution to sustainable development.

2. Assumptions

In many ways the Doha decision to elaborate a FVA, and develop modalities and procedures for the NMM, is leading us to prepare for a climate change regime/framework that is yet to be defined.

This increases the complexity of the discussion, as many unknowns have to be addressed and provided for. However, as the science tells us through the Intergovernmental Panel on Climate Change (IPCCC) report, doing things sequentially (i.e. waiting to 2015 to start discussions on the FVA), is simply not an option.

What is important, however, is to develop M&P for NMM, and elaborate a FVA that is resilient enough to ensure continuity: one that works during KP2, and that does not have to be changed post-2020.

We should also think of the FVA and NMM as potentially being developed in step-wise approach, with different elements being finalized at the appropriate time. It may be possible to developed certain elements in advance of knowing what climate change architecture will look like, while others may need to wait until other elements, such as accounting, reporting compliance is determined in 2015, or maybe beyond. This will be further elaborated below.

In order to discuss the FVA, some basic assumptions that provide the building blocks of the new climate change regime need to be made. Therefore, this submission is based on a number of assumptions, namely:

1. There will be an international climate change regime under the authority of the COP.
2. It will have end-of-period compliance obligations where units used for meeting obligations/compliance will have to be accounted for with the COP, who is the regulator.
3. There will be an end-of-compliance period inventory.
4. There will be no AAUs.
5. Some countries will have economy-wide caps or targets. They could be developed countries, or developing countries, that choose to present their efforts in this way.
6. Countries that transfer outside the country a unit, will add to their inventory that amount of CO_2 (e.g. +1). Countries that receive the unit transferred will see their inventory go down by the same amount (e.g. -1).
7. For the purposes of this paper NMM will be considered to include a Sectoral Trading Mechanisms and a Sectoral Crediting Mechanism.
8. Other carbon market mechanisms will emerge regionally, nationally or sub-nationally, and will produce units according to their own standards, not subject to UNFCCC authority. We will label them **Domestic Market Mechanisms (DMM)** here. The units produced by DMM will be used for domestic compliance in the jurisdiction where they were produced. EU ETS (EUA), Japanese Bilateral Offset Crediting Mechanism (BOCM) and Australian ETS units, and others, are in this category.
9. There will be a linking of DMMs in different jurisdictions, with domestic units being provided with recognition and acceptance for compliance in the systems that are linked.

10. In some cases, there will be a desire for those that import domestic units originated from DMMs in other countries to use them, at the end of the UNFCCC compliance period, to comply with their obligations under the UNFCCC.

11. The COP will have a role to play, yet to be defined, through its reporting requirements, on what it is used to comply with any commitment undertaken under the UNFCCC. One scenario is for the COP, as the Regulator, to be in a position (as it is now under the KP) to provide recognition for the units that Parties can use to comply with UNFCCC obligations. How that can be accomplished is further discussed below.

3. Framework for Various Approaches (FVA)

The FVA is a set of components and rules that will ensure that all approaches used for mitigation will meet certain standards, especially from an environmental integrity point of view. The FVA will ensure that all mitigation approaches are integrated, and receive recognition, for UNFCCC compliance.

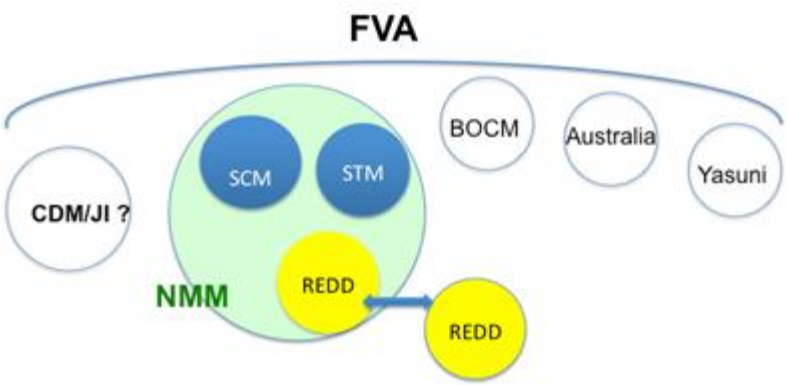
More specifically, through the FVA, units created by a DMM in a jurisdiction will qualify, under certain conditions, to be used for compliance with UNFCCC obligations, by a jurisdiction other than the one under which they were created.

The FVA is not concerned with activities that are purely of a domestic nature and do not result in international transfers of units in one way or another.

A fundamental principle 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 will cover all mitigation approaches, by the created domestically or internationally, as illustrated in Figure 1.

Figure 1: Scope of the FVA



The points made above are based on the assumption that only the COP has the prerogative to provide recognition for units used for UNFCCC compliance. If that is not the case, and any units can be used, independent of any COP recognition, then the FVA takes on the role of safety net, providing, almost voluntarily, minimum standards for the characteristics of the units used.

New Market Mechanisms

NMM are envisaged to have a number of characteristics, with few of them enshrined right now in any decision text:

- The NMM will be mechanisms that will incentivize GHG reductions and will be designed, created and operated under the authority of the COP. If the CDM did not exist it could potentially be created as a NMM.
- They will be sectoral in nature as UNFCCC and project-based, even if the project-based approaches already exist (CDM & JI).
- NMMs will be used by Parties on a voluntary basis.
- The output of NMM will be available for domestic or international use, at the discretion of the Host Country. A NMM could be used to produce reductions for domestic purposes, but more likely, to produce reductions that will be within conditions envisaged by the Host Country, available to be traded internationally. One important choice that Parties will have to make is whether to use a NMM OR develop a domestic approach, in which case they would have to enter the international system through the FVA, should they choose to do so.
- NMM will provide some degree of flexibility, and choices, made to reflect national preferences and realities.
- NMM could be crediting or trading in nature. REDD+ can be envisaged as a NMM.
- NMM will be operated at the national level. Issuance of reduction units will therefore have to take place at the national level, which is a departure from project based mechanisms.
- They could be national, regional or sub-regional in coverage as long as the national authority provides recognition in from of the COP
- From a governance point of view, some decisions will be solely made at the domestic level, while others will have international guidance with domestic application. Establishing the right balance will be they key to success and whether NMM will play a role or not. Establishing baselines and crediting thresholds (crediting systems) or caps (trading systems) at the pure national level can lead to the fear of new "hot air". That will be the case when there is no national cap. As such, baselines for NMM will be defined nationally, under international guidance, and then reviewed periodically.
- As a UN defined and operated mechanism, NMM will be automatically part of the FVA. That is in comparison with DMM which will be part of the FVA under conditions that will be part of the post-2020 climate change agreement, and will be discussed further below.
- There will be a yearly audit-type mechanism regarding the national operation of NMM. Any liability for excess issuance due to improper operation will accrue to the Host Country. The audit will be undertaken by the international regulator. The international regulator will have the power to refer any deficiencies to a body that that will act in a manner similar to the existing Compliance Committee. Similar provisions will apply to any NMM that will have ex-ante issuance of units, and not meet compliance obligations – there will have to be a Host Country liability.
- Given the difficulties of operationalizing a Host Country liability, an insurance pool approach will have to be applied with the participation of all Parties that have DMM or NMM linked into the FVA. Alternatively, a multilateral body, such as the Green Climate Fund, could provide the backstop, under conditions that it negotiates with the Host Country.

4. Why is the FVA necessary?

The carbon market is by definition a regulatory market, and is being created to ensure that it minimises the overall cost to society of reaching environmental targets. As such, it is a price

discovery mechanism that will help produce an economically rational asset allocation process. It exists to put a price on the ton of CO_2 that is reduced in different jurisdictions.

4.1 Environmental value

The very nature of the carbon market creates two values: an environmental value and a monetary value.

The **environmental value** represents the number of compliance tons of CO_2e (carbon dioxide equivalent) a unit issued in a jurisdiction is worth for compliance. This is something that the regulator decides upon, based on standards it can define, and potentially modify. This is not something that market participants can negotiate. It is a fixed value in terms of compliance, until the regulator decides otherwise.

Only the regulator can decide that a unit, issued under certain Monitoring Reporting and Verification (MRV) regime, and other conditions, equals one ton of CO_2e (or a percentage thereof) for compliance purposes. A regulator is free to accept or reject a unit for compliance, if that unit was not created according to specifications that it had defined, and over which it had no control.

Monetary value is one that is determined in the market place, and is what a market participant is willing to pay for that unit. It will fluctuate according to the:

- Liquidity of the unit in the marketplace
- Supply/demand balance
- Acceptance of the unit for compliance in different jurisdictions
- Environmental value of the unit

The FVA is needed because the Environmental Value is NOT a function of market forces, but a decision of the regulator that sets the rules for the climate regime and the carbon market that serve its purposes. The market cannot set environmental exchange rates for compliance purposes between units issued in different jurisdictions. Only a regulator that accepts different types of units for compliance can make that decision.

Rating agencies can provide a rating that will influence the Monetary Value of different units. The Environmental Value in different jurisdictions will be one factor that will impact the Monetary Value of a unit.

4.2 Good market functioning

Good market functioning is highly dependent on having a liquid market, one that trades. With the notable exception of a few large countries, most economies are unlikely to have economies large enough to allow a liquid carbon market to function. Linking will not be a requirement for a jurisdiction that creates a carbon market. The linking of carbon markets will be seen as a necessity, and not a luxury.

Following the same logic, it is difficult to see how linking would take place in the absence of an FVA. It is unlikely that a Party would enter into linking agreements if it cannot have the assurance that units coming from a DMM in another jurisdiction can be used by that Party for UNFCCC/International compliance.

5. Objectives

The FVA that will have as objectives to ensure that:

1. Reductions from ALL mitigation approaches that create and transfer units internationally to be used for UNFCCC compliance obligations can be integrated into the UNFCCC system. This includes carbon markets (created nationally, regionally or sub-nationally) that create, but then transfer, the units outside the jurisdiction where they were created, for those units

to be used for UNFCCC compliance. As mentioned above, that is equally true for reductions that are created through non-market approaches.

2. There is environmental integrity in the units that are being used for compliance with UNFCCC obligations. As there is no definition of environmental integrity, this will be an important element to define.

3. That accounting can be accomplished at the end of the compliance period. Accounting itself is not an objective or function of the FVA, providing the information is.

4. There is no double-counting. The architecture that we are moving to is going to be a complex and fragmented one, with units issued by different authorities. The danger of double-counting is high, and special care has to be taken to avoid endangering environmental integrity. It must also be noted that there are a number of types of double-counting.

6. Scope

The FVA, within the objectives outlined above, will have the following scope:

1. It will be under the authority of the COP. The FVA serves the objectives above, and can only function under the authority of the body that has created it, and whose objectives it serves.

2. It will include developed and developing countries. Some view the FVA as ensuring the export of credit-type units from developing to developed countries. It will have that function, but much more. The FVA should also cover linkages between developed countries. Actually it would be only mechanism to do so under the UNFCCC.

3. It will have ability to integrate both crediting-type mechanisms, as well as trading ones.

4. It will cover only those approaches, mechanisms (and units resulting from them) that are used for UNFCCC compliance outside the jurisdiction where they were issued. The FVA will have no jurisdiction over activities that are of a domestic nature only, and do not affect the integrity of the international climate regime.

7. Components

The FVA may, in a final stage, include a number of components:

a) **International Compliance Unit (ICU)**. The ICU, once issued, is a unit that will be good for compliance with UNFCCC obligations. An ICU will have the following characteristics:

   a. A domestic DMM unit can become an ICU, as discussed below.
   b. An ICU is issued by the International Transaction Log (ITL), once the DMM that creates it accedes to the FVA (and becomes an International DMM).
   c. ICUs are good for international compliance.
   d. Once issued, they can be transferred freely between national registries.
   e. ICUs will allow the identification of the origin of the unit (approval track, country, project, vintage, etc.).
   f. An ICU will be recognised in any commercial transaction as being accepted for compliance with UNFCCC obligations and contribute to a more liquid market.

b) **Standards for Environmental Integrity (SEI).** This will be a set of standards that preserve the environmental integrity of the international system. The SEI will be approved by the COP, and is the standard used, through a process to be defined, and discussed below, to determine if a DMM can accede to the FVA. The SEI will include:

   a. Additionality, where appropriate
   b. Baseline methodologies and crediting threshold

c. An MRV approach
d. Third party verification

It should be emphasised that while the SEI will be defined and approved at the international level, many elements will be defined and determined in cooperation with the national level etc. As such, some interaction is necessary between the national and international levels, for the SEIs to address local realities.

c) International Transaction Log (ITL) – will have a number of functions and characteristics

a. Will be operated by the UNFCCC
b. Will be able to issue ICUs upon verification that they are issued for a unit originated from an DMM that has acceded to the FVA
c. Can accept filtering instructions with respect to the origin of ICUs. These instructions will be publicly available and will contribute to the development of a liquid market.
d. Will transfer ICUs between National Registries.

d) Market Regulatory Board (MRB). This regulator will have the following functions and characteristics:

a. Established under the COP
b. Its functions will be technical in nature such as developing standards, undertaking audits, etc.
c. Will cover all mechanisms used internationally – NMM, International DMMs, (potentially CDM?) etc.
d. Will review DMM submissions for accession to the FVA through a process that is to be determined and that is discussed below (T1 and T2). It will do so under strict rules and standards, approved by the COP. All decisions regarding the accessibility of an NMM will be reviewed and confirmed by the COP.
e. Will undertake audits of all mechanisms linked to the FVA
f. Will refer any deficiencies observed in any mechanisms during the audits in any mechanism linked to the FVA to a Compliance Body
g. Will develop, implement and monitor the SEI, as discussed above.

It should be underlined that the CDM EB is an international regulator for carbon markets that already exists. Other bodies with regulatory powers also exist within the UNFCCC. As such, this is not a new development, and does not call for the creation of new bodies under the UNFCCC, but simply the transformation, and possible amalgamation, of existing ones.

e) Compliance Body. It will function in **manner similar** to the existing Compliance Committee with a Market Facilitation & Transparency Branch (MFTB) and a Market Approval, Audit & Enforcement Branch (MAAEB).

a. The Facilitation & Transparency Branch will
  i. Undertake Peer Reviews under T2 (see below) and work with Parties to provide input on submitted DMM.
  ii. Work with any DMM referred during the annual reviews of the Market Regulatory Board to rectify deficiencies.

b. The Market Approval, Audit & Enforcement Branch will
  i. Review and rule on the findings of the Market Regulatory Board on any DMM examined under T1 (see below).

ii. Examine and rule on audit cases referred by the Market Regulatory Board each year for deficiencies that the Market Regulatory Board identified in the audited material filed by DMM.

f) National Registries (NR)

a. The NRs will be operated by authorities at national level.

b. NRs will be linked to the ITL, and will issue domestic units, for domestic compliance.

c. Once a DMM has gone through the process of the Market Regulatory Board, a National Registry will be able to request the ITL to issue an ICU for any unit domestic unit that needs to be transferred internationally.

8. Functions of the FVA

The FVA will accomplish its objectives by fulfilling the following functions:

1. **Develop and maintain the Standard for Environmental Integrity for approval by the COP**

2. **Accession to the FVA - review DMMs according to the SEI.** The FVA will have three tracks, **with Parties having a choice on which Track to use**

T0 – Automatic Linking Track. This applies to NMMs from countries that have UNFCCC absolute caps. In this case, any unit issued is "guaranteed" by the overall country cap, and the DMM has to provide transparency, similar to T2 below, but does not go through a peer review process. The same process also applies to DMM that are the operationalization of a NMM.

T1 - Approval Track. Under T1, the Market Regulatory Board will review DMM applications for accession to the FVA, and refer the decision to the Compliance Body (Approval, Audit and Enforcement Branch). If approved, this will entitle any units issued by that DMM to become ICUs. The decision point is the Approval, Audit and Enforcement Branch.

T2 - Review and Transparency Track. Under T2, the Market Regulatory Board will review the DMM information submitted for completeness, and refer it to the Market Facilitation & Transparency Branch. The Market Facilitation & Transparency Branch will oversee a Peer review process and work with the Party to improve any deficiencies to the extent that the Party is willing to do so, using the Standards for Environmental Integrity as guidelines. Once the Peer review is completed, the results of the Peer review will be published. There is no approval process under T2. Once a DMM goes through T2, it also becomes an "international" DMM, and its units can become ICUs.

Different alternatives can be envisaged, depending on the assumptions made. For example, *T2 can be the default track, with T1 only used on demand*.

T1/T2 can be envisaged as a public process, including a hearing-type approach.

It is assumed that the "market", driven by environmental quality considerations, which would will be a deciding factor for units from a DMM to get accepted for compliance in any specific jurisdiction (as was the case large dam projects) will push most DMMs to T1.

2. **Transfer units internationally**. The FVA will ensure that, upon request, units are transferred between national registries.

3. **Tracking units internationally**. The FVA will ensure that ICUs are tracked internationally, and that it has all the information to locate any particular unit at any given time.

4. **Issuance of ICUs**. Through the ITL, the FVA will issue ICUs for any DMM unit, upon demand, and upon the DMM going through TI or T2.

5. **Avoid double counting**. Double counting will be checked, by the national registry (NR), at the national level, upon issuance of domestic units. A national registry will have all necessary data to identify projects and installations that are in that jurisdiction.

A national registry will also have data on any UN mechanism, such as CDM, as they need to issue a Letter of Approval. To have double counting checked internationally would imply that the regulatory body, and/or the ITL, would have to track all DMMs, in every country. This is not efficient, and not in keeping with the fundamental principle of doing things at the national level wherever possible.

6. **Environmental exchange rate setter**. While may of the DMM will result in clear GHG reductions, it may be that others may be quantified in other units, such as Energy Efficiency (EE) or Green Certificates. As mentioned the only entity that can set an Environmental Unit is the Regulator. Consequently, the Regulator, through the FVA, may need to set an exchange rate (e.g. for a EE certificate) into CO2.

9. Net avoidance of emissions

The Durban decisions, and all recent discussions, have made it clear that an offsetting approach is not one that can be contemplated. Under the new climate change regime what is needed are net emission reductions.

Based on the points raised above, we see and expect the emergence of a variety of approaches around the world. Net emissions reduction can be achieved in a variety of ways but ensuring consistency at the source of production of these reductions may require a great deal of effort and coordination – such as ensuring that the same definition of conservatism is applied in very different circumstances and jurisdictions.

A different approach may be one where a discount factor is applied consistently at the point of use, which will have the effect of keeping clear measurement to 'a ton is a ton', and not making arbitrary and differing conservative assumptions. At the same time, applying a discount factor at the point of use ensures a simple and clear net reduction.

10. Financing of the FVA

The CDM is financed through the Share of Proceeds from the issuance of CERs. In this case the situation is more complex as the FVA will only cover internationally transferred units, many issued at first domestically.

We recommend an Issuance Levy (like in the case of the CDM) on all ICUs issued by the ITL. This will capture only units that use the FVA for international transfer and compliance purposes. The levies will be transferred to the Green Climate Fund.

11. Functioning

Based on the assumptions made in point 2 above, there are two distinct scenarios that emerge: one for countries that have economy or sector-wide caps, and one for those that do not have such caps.

Countries/sectors of the economy with caps

This applies to countries that may choose to make UNFCCC commitments as a country wide/sector wide cap. In this case the country will use T0 outlined above.

In this case, any DMM unit that is issued domestically, and then transferred as an ICU, will be added to the inventory of the issuing country/sector, and will be accounted for at the end of the compliance period.

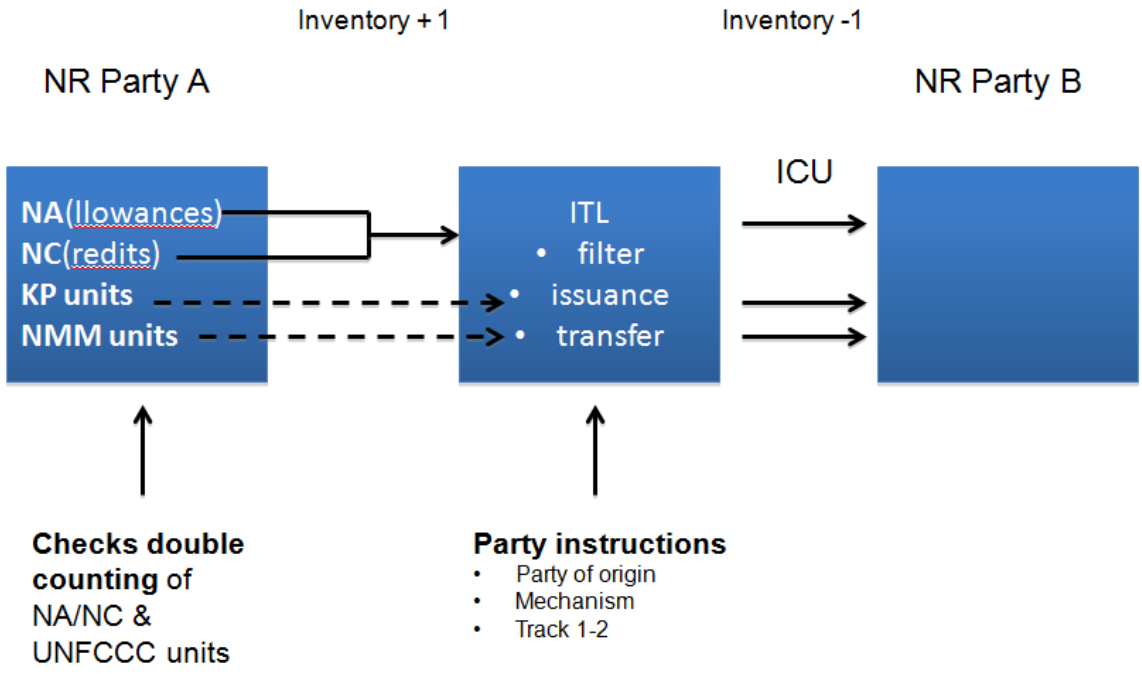
This system can be deemed as *ex post*. However, modalities to ensure its functioning will need to be worked out as part of the climate change regime, not the FVA.

As such, it can be said that Parties that have economy-wide caps and transfer units internationally 'guarantee the environmental integrity' of that unit. Any country/sector with a cap can request the issuance of ICUs for their DMM.

For illustration purposes, the EU can request the issuance of an ICU for a EUA, without having the EU ETS having to go through T1 or T2. It will use T0. The EUA is 'guaranteed' by the EU inventory at the end of the compliance period. Having a country-wide UNFCCC cap allows the EU ETS to be linked to the FVA without any pre-conditions

Figure 2 illustrates the mechanics of the issuance of an ICU and its transformation and transfer, from a domestic unit from a Party with a cap.

Figure 2: Process flow – Parties with caps



When a domestic unit is issued, the NR checks for double-counting, as it will have all relevant information in its databases, including all activities under DMM, VCS, CDM, etc. Once the domestic unit is issued, the owner can request the NR to issue an ICU.

That request is transmitted to the ITL (by Party A), which verifies that it is issued from a DMM in a Party with a cap and can use T0. The ITL then issues the ICU, and, prior to making the transfer, checks any filtering instructions from the receiving Party (Party B).

If the request for transfer is for an ICU, or a unit from an UN-issued unit (e.g. CER), that transfer is done automatically, after filtering instructions from the receiving Party are checked.

From a transactional point of view this is totally transparent as the owner of the sending account is notified that the transfer has taken place for X number of units, and its account debited accordingly. For the receiving account, the owner is notified that it has receiving X number of ICUs with the respective identifiers.

Countries without caps

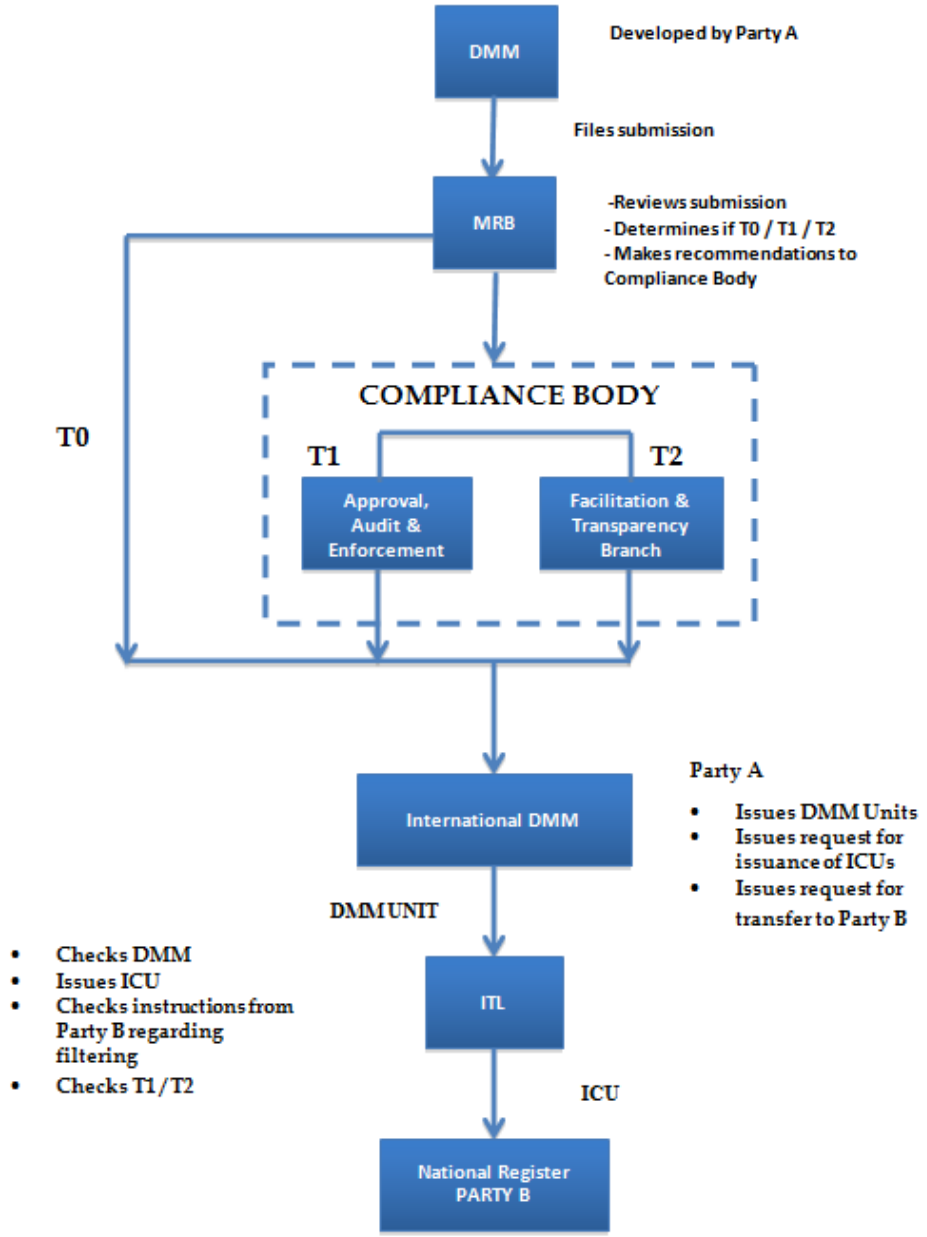
In the case of countries without a cap, there is no end of compliance period obligation. As such, there is no guarantee by the issuing country of the environmental integrity of the unit that is first issued domestically, and for which it then requests the issuance, and international transfer, of an ICU.

As such, any DMM that requests units to be transferred internationally, to be used for UNFCCC compliance, will need to go through a T0, T1 or T2 process. Figure 3 illustrates the flow of the process in this case.

If a DMM from a Party without a cap is submitted for accession to the FVA. that Party has a choice of tracks.

If it chooses to go through T1, then the MRB will review it, and make a recommendation to the Approval, Audit & Enforcement Branch, which will have the authority to approve or reject it.

Figure 3. Process Flow – Parties without caps



The DMM will be tested against the already defined, and COP approved, Standards for Environmental Integrity. It must be again noted that it will be the DMM, and not individual units that are the object of the review. Once the DMM is approved, any domestic unit issued by that DMM may be transformed, upon request, for an international transfer into an ICU.

If the Party chooses T2, then the DMM will be submitted to the Market Regulatory Board. The MRB will examine it, and submit it, together with its findings, to undergo a Peer Review process run by the Market Facilitation & Transparency Branch.

Once the process is completed, the results of the review are published, and the DMM becomes an International DMM, which can request the issuance of ICU for any domestic units it issues.

At that point, any owner of a unit issued by that DMM may ask for an international transfer to another NR. The ITL will issue an ICU and that ICU will not be treated any differently from any other ICU.

12. Recommendations

In operationalizing the FVA and the NMM, there are two sides that need to be reconciled. On one hand both the NMM and the FVA will take a significant amount of time to operationalize, as the modalities and procedures need to be developed, capacity and infrastructure built, etc.

In addition, DMMs are being currently developed (not sometime in the future – EU ETS, Japanese Bilateral Offset Mechanisms, Australia and California cap and trade). Real linking is taking place (Australia/EU), etc.

This would point to the need for an early start, in order to have a learning period, and have the whole system operational by 2020.

At the same time, especially on the FVA side, the final format will heavily dependent on the post-2020 agreement. As mentioned before, we are trying to develop an FVA for an unknown agreement. The discussion above is based on certain assumptions, but the final outcome of the ADP and the post-2020 agreement may be very different.

That is why we need flexibility and the ability to adapt to the different types of architecture that may emerge.

As such, it is recommendable to have a step-by-step approach, which would recognize that only part of the elements should be developed ahead of the 2020 agreement, through a Pilot Phase.

A Pilot Phase (Step 1) could have two components

1. **An FVA Pilot Phase. A Pilot phase for the FVA should be the implementation of the Review and Transparency Track. This in our view does not need to pre-judge the outcome of negotiations under ADP. Implementation of the Approval Track should be considered with the finalization of the post-2020 agreement under ADP.**
2. **NMM Pilot Phase. Another part of the Pilot Phase should be the development of a Pilot Phase for the NMM.**

Implementation of each Pilot Phase should not be conditional upon the implementation of the other.

A Pilot Phase could prove to be beneficial from a number of perspectives, as it would allow to:

- Incentivize the early development of new domestic approaches, within a common framework of the UNFCCC, and learn the realities of how to operate such a complex interaction
- Understand how to design NMM, how they will work, and ensure that they meet the guidance that Parties have provided so far

- Discover, under UNFCCC, common disclosure guidelines, the type of domestic mitigation actions that are starting to emerge and their characteristics, including concerns related to their environmental integrity
- Start to develop and operationalize a way to integrate international and domestic mitigation actions under the UNFCCC umbrella, with a minimal touch, but without compromising environmental integrity
- Understand the role the UNFCCC can play in ensuring that mitigation actions, developed domestically, can be trusted for meeting international obligations
- Understand the relationship between the approaches that are emerging at the domestic level, and those developed at the UNFCCC level
- Understand what is real and what is not – what is needed, and what is not - in putting together a framework for the diversity of emerging domestic mitigation approaches. What is simply a centralizing reflex, and what is an absolute necessity?
- Build capacity gradually, by using the existing experiences.
- Use existing infrastructures, nationally and internationally, that has been developed for the Kyoto mechanisms
- Not pre-judge the conclusion of the 2015 negotiations

A Pilot Phase for mitigation approaches under the UNFCCC should have a number of characteristics and elements. This list is not exhaustive.

- **Under COP**. Be under the authority of the COP, that is, its rules will be approved by the COP, with the specific purpose of serving as testing ground for the development and approval of permanent rules.
- **Continuous evolution**. Ensure that the Pilot Phase is reviewed at each COP and can be updated, to account for lessons learned.
- **Early action**. Mitigation approaches that are reported under this Pilot Phase, and reductions resulting from them, will be considered as early action, for use in the post-2020 climate change regime, without prejudicing the outcome of negotiations.
- **Existing infrastructure.** When possible, use existing infrastructure to avoid duplication and reduce the need to reinvent the wheel. This will also facilitate co-existing between existing KP mechanisms, and new mitigation approaches.
- **Cooperation**. It should cooperate closely with existing efforts such as the World Bank's PMR.
- **Voluntary**. Parties will include domestic approaches in the Framework only if they decide to do so.
- **Net Emission Reductions**. All approaches included in the Pilot Phase will have to lead to net emissions reductions, though conservative assumption, discounting or other such measures.
- **Scope**. It can include actions that cover:
    - Internationally developed NMMs and domestically developed mitigation actions
    - Individual projects as well as broader sectors of the economy
    - Reductions and sequestration
    - Crediting or trading
    - Developed or developing country
- **Facilitation, Transparency & Review**. The purpose of this Pilot Phase is to develop a sense of trust and confidence in the diversity of mitigation actions that are emerging, by playing a facilitative role. It will also provide a venue for review and transparency for submitted domestic initiatives. It may:
    - Provide feedback to the Party submitting an activity, in order to ensure continuous improvement.

    - Work to improve submitted mitigation approaches.
    - Create templates for reporting.
    - Review the information received through a group of experts.
    - Publish the information disclosed in a consistent format.
- **Elements of a Pilot Phase** could include (but not all elements are necessary for participation in the Pilot Phase)
    - *Domestic authority* in the jurisdiction where the mitigation initiative is created, to
        - Liaise with the UNFCCC
        - Ensure that there is no double counting
    - *Reporting templates* for crediting, trading, as well as non market mitigation approaches
    - Mixed *technical expert group* that will
        - Include experts from Parties as well other sectors of society
        - Develop reporting templates for disclosure of information by mitigation initiatives for review, as well as for public disclosure
        - Review and provide feedback to Parties on the substance and operation of any action that is submitted for inclusion in the Pilot Phase
        - Monitor consistency between different approaches submitted
        - Develop a body of knowledge that will be available to all Parties

Step 1 – COP 19 (Pilot Phase)

1. Start developing the Modalities & Procedures for Sectoral Trading and Sectoral Crediting. This should be done in SBSTA. There are excellent submissions by Parties, especially the EU one, which can make the basis of negotiations going forward.
2. Once the NMM Modalities & Procedures are approved by the COP, they should be made available for implementation by the Parties that want to start NMM in their jurisdictions.
3. Start development and implementation of the T2 of the FVA, as outlined in the body of this submission. The starting point should be transparency and understanding what has been tried in the real world.
4. The Market Regulatory Board could be hosted, on a temporary basis, by the UNFCCC Secretariat and the CDM EB. However, the MRB should have a distinct structure, with its own Head, reporting to the COP.
5. Develop the Standards for Environmental Integrity, DMM reporting templates, DMM audit procedures, for T2 etc. under SBSTA.
6. Create the appropriate Market Facilitation & Transparency Branch which should be hosted, on a temporary basis, by the Compliance Committee.
7. Start a Pilot Phase consisting of point 1 - 6 above at COP 19 in Warsaw.

Step 2 – post 2015

1. Examine the post 2020 agreement and determine if T1 is needed
2. If needed, establish a Approval, Audit & Enforcement Branch

There are many ways that the FVA can be approached, depending to a large degree on what the OUTCOME OF THE ADP will look like. That is why the some elements, such as the Compliance Body and the MRB could be merged into a single step, with a body that could be technical or political in nature.

The governance of the regulatory body vis-a-vis the UNFCCC could also lead to a number of solutions. If technical in nature we could have the work done in the UNFCCC Secretariat or in a CDM EB-like body. If the feeling is that this would be more political, it could be a Compliance Committee type body.

There are also functions that were mentioned, but not elaborated on, such as the Environmental Exchange Rate Setter, that could equally be part of the architecture. Other ideas had been mentioned by the High Level Panel on the CDM Policy dialogue, and could also be part of the functionalities of the FVA.

This paper must be seen as outlining number of functions, possible decision flows, etc that could be combined and /or simplified.