CARBON MARKET FORUM

CEPS Thinking ahead for Europe

CEPS Submission on FVA

This submission, on behalf of the Centre for European Policy Studies, is in response to the call for submissions that was launched in the Conclusions of the Chair in document FCCCC/SBSTA/2013/L.6. Some of the ideas in this submission have also been developed in a previous submission dated March 2013.

1. Role of the Framework for Various (FVA)

1.1 What is the purpose and scope of the FVA, including its role in ensuring environmental integrity?

The FVA is a set of components and rules that will ensure that all approaches used for mitigation and compliance under the UNFCCC, 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 – the FVA will integrate various mitigation approaches from an accounting point of view.

More specifically, through the FVA, units created in a domestic 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.

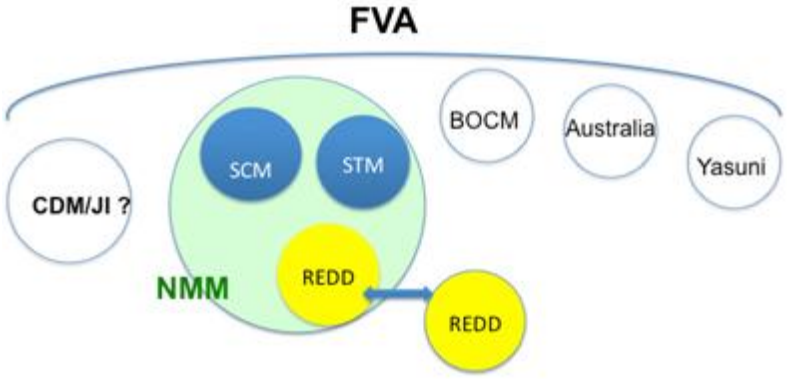
The FVA is not concerned with activities that are purely of a domestic nature, and do not result in international transfers of units in one way or another.

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, be they created domestically or internationally, as illustrated in Figure 1. It must be clarified that the FVA will cover mitigation action that are created and operated under the authority of the COP.

The FVA will cover units from DOMESTICALLY created and operated mitigation approaches if those units have acceded to the FVA, by meeting core characteristics agreed by the COP, through a process that yet to be defined. The graph below is not to be interpreted as statement that non-UNFCCC mechanisms (outside CDM, JI, NMM) have already agreed to have standing under UNFCCC – that is a debate that has yet to take place.

Figure 1: Scope of the FVA



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

Background

Currently the Kyoto Protocol (KP) provides for three mechanisms that were developed, and are operated, under the authority of the CMP. They are CDM, JI and International Emissions Trading (IET).

An international regulator, CDM EB or JISC, which operates under the authority of the CMP, regulates them. Units emerging from CDM and JI, as well as AAUs used in IET, are used for compliance with the KP and cross international borders.

In addition, COP 17 in Durban defined a New Market Mechanism (NMM) that will also operate under the authority of the COP. This NMM is currently ill defined and not well understood, but it is clear that it is also operating under the authority of the COP. It is also unclear what will be the units of reduction produced by NMM.

In addition, over the last number of years a number of domestic programs have been defined and are being operated. The prime example, and the largest carbon market to date, is the EU Emissions Trading Scheme (ETS), but other examples such as RGGI, the California ETS and the ETS in Australia are also emerging.

EUAs, which are units created by the EU ETS, are used for domestic EU ETS compliance only, and have, so far, not crossed international borders. EUAs are not units recognized by the CMP under the UNFCCC, and have no compliance value for any UNFCCC related obligations. The EUAs are backed up by AAUs as far as the UNFCCC is concerned – i.e. the UNFCCC only sees AAUs for compliance, it neither sees, nor acknowledges, EUAs.

As such, one can say that the current world is "orderly", with international units, used for UNFCCC compliance, being produced under mechanisms over which the UNFCCC has authority.

Any linking being done currently, or contemplated, is done within the "KP club" and is therefore backed by AAUs (Australia & EU). In this case the type of the units that the UNFCCC sees (AAUs), and their recognition, is not an issue, as they are the product of a UNFCCC process.

Alternatively, linking may take place outside the KP (California & Quebec) and as such the issue of international recognition of units is not an issue - it is simply what the two linked entities (California and Quebec) wish to recognize.

The future (post-2020) seems to be emerging differently, with a few basic premises. One of them, and a fundamental one, will be the absence of AAUs, as an internationally recognized unit that can back up any international transfer of domestically created units.

For illustration purposes, how would linking between Australia and the EU function in the absence of AAUs? If a EU company received an Australian Unit in its account and used it for compliance in the EU ETS (which the EU agrees at the time of linking) that would pose no problems as it is a bilateral agreement.

However, the EU could (or should want to) turn around and use it for compliance with its KP obligations. However, the CMP/UNFCCC has never seen or defined an Australian Unit, and as such would have to take the word of the EU, and Australia, that such a unit represents a ton of CO_2 reduction.

In the future, with all Parties having to make contributions to GHG reductions it is expected that some may wish to use market mechanisms. They will have a choice, and while some will use the mechanisms created and operated by the UNFCCC, many will opt to use their own domestic mechanisms.

It can also be expected that there will be a desire to link many of these many GHG markets, and transfer units create domestically to other Parties, which will naturally want to use them for compliance with international obligations under the UNFCCC.

Very rapidly the need emerges for a framework that would allow for the linking of the domestic markets in a way that will allow for

- Ensuring environmental integrity, that "a ton is a ton" – that the mitigation value of the units created domestically, and transferred internationally to be used by another jurisdiction, for compliance with UNFCCC obligations, is **well understood and trusted** by the those that set/accept commitments – the COP, under the new post-2020 UNFCCC agreement. It is very important to note that this can be accomplished in a number of ways. It can be
    - Binary – that is a domestic unit can accede to the FVA if it meets certain core characteristics. It then has a pre-agreed mitigation value, say a ton of CO_2.
    - Through a rating system – in which case domestically produced units can be rated for their mitigation value and assigned one. Ratings of units for financial purposes in the GHG marketplace have a different set of components, and is a function for the private sector to provide.
- Providing the information and the backbone for UNFCCC compliance accounting and for the GHG trading market – by, among others functions, avoiding double counting for compliance, moving and tracking units or reductions between accounts in different national registries.

Scope

The FVA will have the following scope:

1. It will be under the authority of the COP. The FVA 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 will also cover linkages between developed countries.
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.

1.2 What are the possible links between the FVA and other relevant matters under the Convention and its instruments?

The FVA sits at the heart of the new post 2015 agreement and as such its success is critical for the success of the post 2020 climate change regime. This is due to the

nature of the new agreement that is profiling, at least in its architecture, to be a more bottom up, and with fewer centralizing aspects and components.

It is likely to lack AAUs as a common international currency for domestic efforts. It is also likely to rely on a variety of approaches that will be fitted to local needs and as such different in nature.

The emergence of different climate regimes, and markets, for climate related instruments, will also make linking a necessity. Outside the large markets (EU, US, China, etc.) few other markets will be liquid enough and will need to link into the broader international compliance market. Without an FVA that will be extremely difficult to achieve - there will be no consistent and secure tracking, transfer, check for double counting, etc.

It is also likely that international competitiveness, comparative effort and equity will play an increasingly important role in the climate negotiations and positions of Parties, as different jurisdictions take on climate obligations.

As such, the need for a unifying framework that will provide the tools and protocols to bring together a world of a variety of approaches will become evident. It will be a necessity, and not a luxury.

1.3 Should the elements of the FVA operate under the principles, provisions and commitments of the Convention, and if so, how?

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 is also integrated in the ADP track of negotiations.**

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

It must be understood that the FVA has a recognition and inclusiveness role. It must not be confused with the **approaches** that it aims to integrate under the UNFCCC. As stated above the FVA looks at the international circulation and integration of units and reductions (and their characteristics) produced from domestic instruments.

As such, the provisions and principles of the Convention will need to be integrated into the characteristics of the FVA, but only to the extent appropriate. For example, CBDR reflects upon the commitments and actions that Parties will take under the Convention. However, the approaches that are integrated under the FVA into the UNFCCC represent means of achieving those commitments.

2. Technical design of the FVA

2.1 How many of the elements listed in decision 1/CP.18, paragraph 46, should be elaborated given the options for the purpose and scope of the FVA expressed by Parties?

The FVA is at the heart of the new climate regime that will be developed post-2020. The FVA is also essential, in a bottom up approach, to the development and expansion of the carbon market.

As such, the elements that are listed in paragraph 46 are a good start, but not an inclusive list of what needs to be part of the work program to make the FVA operational. The list is an overview and needs to be further developed into subcomponents such as the characteristics of the units, a protocol for accession of units to the FVA, etc.

Other elements that should be included will be the development or adaptation of Transaction Log, the development of National Registries for Parties that do not have a registry currently.

It is also important to note that the work does not need to be sequentially. The FVA is critical to development of the carbon market and the post-2020 agreement, and cannot become gridlocked, waiting for outcomes that will only be resolved at the last moment of the negotiations in 2015, as part of the broader political agreement.

As such, a start up or Pilot phase, started sooner, rather than later (preferably in Warsaw), is imperative.

The development of the key components of the FVA (unit characteristics, registries, transaction log, tracking protocols, double counting provisions, etc.) does not have to wait for difficult political decisions such as how do units accede to the FVA (approval or declaration) and how and when they are used and produced (pre- or post-2020).

It is imperative that the FVA has an early start by developing and piloting ELEMENTS of the FVA. This can be accomplished by the setting up in Warsaw of a "Transitional Committee for the FVA", not dissimilar in nature to the GFC Transitional Committee.

The development of the FVA will be challenging and needs to start early to allow for sufficient time to road test its components and to develop infrastructure and capacity in all Parties.

2.2 What experiences from the Kyoto Protocol flexible mechanisms, domestic and regional schemes, existing institutional arrangements and infrastructure are relevant to the elaboration of the FVA, and how can they be applied to the FVA?

There is a wealth of experience that was learned from carbon markets, especially as they relate to the EU ETS, CDM, JI, and their interaction.

While the KP has been seen as flawed by many for political reasons, the market component has actually provided a good environment that has allowed carbon markets to flourish and learn.

While some aspects have been negative (CDM has taken a long time to get to what it is today, and many improvements are still possible), there have been many positive aspects, especially as they relate to infrastructure.

As such, while the climate change regime will change, and many of the positive aspects will disappear as components of the old regime also vanish, some elements need to be retained, or need to be re-created in the new architecture and conditions.

Among the obvious examples of elements to keep are the ITL and National Registries. As AAUs will likely disappear as a linking element, the FVA will have to produce a series of components and protocols that will mimic their function of back stopping and providing a fixed environmental value for domestic reductions.

Other lessons learned from the current carbon market will include:

- Market infrastructure was part of KP, and it played a critical role in accounting and compliance for the CDM. Participation in mechanisms by the Parties on a voluntary basis was subject to compliance with conditions under the authority of the CMP. If a Party did not meet certain conditions, then it could not issue units, nor use units from market mechanisms. This was a very real situation that did affect some Parties. The International Transaction Log (ITL) played a critical role in ensuring that units were tracked and there was no double counting.

- Those who created the obligations for compliance had the authority to decide what units could be used for compliance. Compliance obligations for Parties with the KP were set under the CMP. All units that could be used for compliance with the KP were issued under the CMP's authority. That ensured, in a very simple way, that the CMP knew the "environmental/mitigation value" of each unit used for compliance (1 ton). Through the fact that only CMP approved or issued units could be used for KP compliance, there was recognition that the "environmental

value" of a compliance unit can only be set by those who set the constraints. This is a fundamental issue in any regulatory regime. However, an additional principle also needs to be recognized and accepted, namely *how* that recognition is provided, which is also something that the Regulator (CMP) also has the authority to decide upon. ERUs were issued through T1 and T2 either under international supervision or at the purely domestic level, with little international intervention by the CMP regulator, the JI Supervisory Board.

- A number of the controversies that emerged regarding the functioning and contribution of carbon markets to mitigation efforts were caused by the discontinuity resulting from the largely uncoordinated objectives and rules of the currently existing two market levels (UNFCCC regulated and domestically regulated). This is in itself a critical issue that needs to be recognized and addressed in the new climate change architecture that will emerge from the ADP.

- **Process Politicization**. The process of running and administering the KP mechanisms has been heavily politicized. Efforts have started in that direction and provisions need to be introduced, including an appeal process, to ensure checks and balances.

- **Clear objectives.** The CDM was the flagship of the KP market mechanism, but its duality of objectives has led to strong debates on the contribution it has made to real reductions, as well as to sustainable development. The lesson that needs to be internalized in what is a pure regulatory market is that the lack of clarity in objectives will damage the credibility of the market, affect the social license to operate, and finally impact on its good market functioning. Examples are the dispute over the objectives of the EU ETS, namely compliance within the period cap or long-term de-carbonization. Similarly, when it did not meet the purity tests of some, the Sustainable Development (SD) objective of the CDM has been interpreted as casting a negative light over certain projects and technologies. However, adding the SD conditionality as a market constraint, a concept not quantified, muddies the waters in a way that markets cannot understand.
  Whatever conditionality is introduced, it needs to be clearly spelled out for markets so they can quantify it and operate within it.

- **Competition and leakage.** The vision of the KP was one of a global price for carbon, which would drive reductions around the world in the most efficient way. However, that was in a "simpler" world, divided into Annex 1 and Non-Annex 1 income countries and emissions. However, as the world changed and the new economic and emissions realities have taken hold, it becomes apparent that, while paying for rapid development was OK, subsidizing competition in globally competitive industries, especially in a time of grave economic crisis, was not acceptable. Carbon leakage is becoming an increasing concern. All these matters need to be accounted for in any new climate change agreement and the FVA used to ensure comparability of mitigation value of units.

2.3 Should the FVA asses the institutional arrangements of VA, and if so, how?

The FVA will have to assess only certain aspects of the institutional arrangements of the FVA. We must again 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 will not affect the integrity of the domestic system and not impact upon its effect on the international climate change regime.

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

2.4 What could be the role of Share of Proceeds (SOP) for the approaches under FVA?

The SOP was the result of issuance of units from UNFCCC mechanisms (CDM & JI). In the future scenarios, most of the mechanisms will be operated domestically and units will, overwhelmingly, be issued nationally. More precisely, some units will be issued nationally and some globally.

Consequently, in order to provide a level playing field between VAs (global and local), consideration should be given for the FVA to have the SOP based on the international issuance of units by the UNFCCC mechanisms, and the first transfer of domestic units internationally.

Alternatively, domestic units issued and circulating internationally could be "re-issued" by the UNFCCC as an International Compliance Unit, with an SOP attached to such issuance.

2.5 What common accounting rules, standards, criteria and /or procedures, if any, could be established under Convention, taking into account internationally agree accounting rules, to ensure the environmental integrity of the approaches under the FVA, and avoiding all types of double counting, including mitigation outcomes and support?

The goal of ensuring the environmental integrity of reductions produced through mitigation approaches that are developed domestically, but are used for UNFCCC compliance internationally can be seen as comprising the following elements

- A ton is a ton. The COP, which will accept the pledges from Parties, should have a way of being reassured that what is being used for compliance truly represents

the amount of GHG reduction that is being represented by the Party which undertakes that mitigation approach. The environmental/mitigation value of a unit must be fixed, while the market value of a unit can float.

- Ensure that there is no double counting of reductions towards UNFCCC agreed pledges – at issuance, as well as at use.
- Ensure that mitigation approaches meet the sustainable development criteria, as defined by the country where the mitigation action takes place
- Ensure that reductions are permanent, which will be critical especially in view of the attention that REDD+ is getting.

It must be emphasized once more that the FVA is not the accounting system of the UNFCCC, but rather provides the information that makes the accounting system possible and functional.

As such, there will be a number of areas where the UNFCCC, at the global level, should produce rules, or standards, that will provide these assurances.

1. The COP should develop a Mitigation Unit Description Document that would ensure that all unit characteristics are described **in a consistent** and **comparable way** - similar to a template.
2. Mitigation Unit Core Characteristics – what are the characteristics of units produced from domestic mechanisms that are to be able **to accede** to the FVA. This should include an MRV description.
3. Accession Protocol for units produced from domestic approaches (non UNFCCC) to **accede** to the FVA and become part of the UNFCCC accounting system. Current tracks/options being considered are Transparency/Declaration OR Approval OR a Hybrid of the two.
4. Standards for National Registries that will ensure that they can communicate with each other and that they can undertake the role of avoiding double counting at the point of issuance of units.
5. Standards for a Transaction Log (TL) to move all units used for UNFCCC compliance (from UNFCCC mechanisms or domestic mechanisms) between National Registries. Also a protocol to ensure that the TL would help avoid double counting at the point of use for UNFCCC compliance.
6. Develop the Global Regulator and ensure that its functions are well integrated with those of the National Regulators.

We must however, again, reiterate the fundamental principle that all activities that can be effectively regulated at a level other than the international one, should be regulated at that level.