INSTITUTE FOR AGRICULTURE AND TRADE POLICY

Submission in response to the request for comments by the Chair of the Ad Hoc Working Group on Long-term Cooperative Action under the United Nations Framework Convention on Climate Change (FCCC/AWLCA/2011/L.4) New market mechanism

March 5, 2012

> 77. *Defines* a new market-based mechanism, operating under the guidance and authority of the Conference of the Parties, to enhance the cost-effectiveness of, and to promote, mitigation actions, bearing in mind different circumstances of developed and developing countries, which is guided by decision 1/CP.16, paragraph 80, and which, subject to conditions to be elaborated, may assist developed countries to meet part of their mitigation targets or commitments under the Convention;
> 78. *Requests* the Ad Hoc Working Group on Long-term Cooperative Action under the Convention to conduct a work programme to elaborate modalities and procedures for the mechanism referred to in paragraph 77 above, with a view to recommending a decision to the Conference of the Parties at its eighteenth session;
> 79. *Invites* Parties and admitted UNFCCC observer organizations to submit to the secretariat, by 5 March 2012, their views on the matters referred to in paragraphs 77 and 78 above, including their experiences, positive and negative, with existing approaches and mechanisms as well as lessons learned;
> 80. *Requests* the Ad Hoc Working Group on Long-term Cooperative Action under the Convention to conduct one or more workshops with Parties, experts and other stakeholders, including an in-session workshop at its session held in conjunction with the thirty-sixth session of the subsidiary bodies, to consider the submissions referred to in paragraph 79 above and to discuss the matters referred to in paragraphs 77 and 78 above.

Introduction

The Institute for Agriculture and Trade Policy (IATP), a non-profit, non-governmental organization based in the United States, has been an admitted observer to the United Nations Framework Convention on Climate Change (UNFCCC) negotiations since the Conference of the Parties in Poznan in 2008. IATP thanks the UNFCCC for this opportunity to submit our views to the Ad Hoc Working Group on Long-term Cooperative Action (LCA), following the guidelines in paragraphs 77-79, cited above from the Chair's conclusions.

The following comment first gives an overview of some proposals for defining the New Market Mechanism (NMM) within the UNFCCC. Then we summarize some governance controversies about the UNFCCC Financial Mechanism under whose aegis, the NMM projects would be carried out and submitted to the Monitoring, Reporting and Verification process. Finally, we raise questions about the financing of mitigation projects under the NMM by means of "green sectoral bonds" (GSB). The GSB should be a central part of the NMM debate insofar as the GSB would facilitate an expansion of emissions offset crediting trading under a 'sectoral crediting' scheme proposed for the NMM.

Like a conventional bond, a GSB is a debt instrument sold to creditors to whom interest as well as principal must be repaid over the duration of the bond. Plain or so-called "vanilla" green bonds are like conventional bonds except that they are targeted to pay for "green" projects, e.g. solar power installations.[1] Unlike conventional bonds, the collateral for the GSB are developing country Party carbon emissions credits, which the bond holders may trade without limit until such time as the bond's principal and compounded interest are paid in full. The "sectoral" part of the GSB concerns their provision of finance for emissions offset credit projects in developing country Parties that may be used by developed country Parties to help them comply with economic sector wide emissions reductions, relative to a baseline.

The discussion of the design, operation and developing country collateral pledged to receive funds from green sectoral bonds is largely absent in LCA reporting of Party positions. And yet such bonds could well become the predominant form of mitigation finance offered to all but least developed countries under an NMM, however defined. Reliance on public finance for the majority of mitigation funding, we are told, e.g. by the United Nations High Level Advisory Group on Climate Change Finance report, is subject to the "politically acceptability"[2] of such funding. Due to developed countries' fiscal crises, triggered by the financial market crises of 2008-2009, and subsequent bailouts of the financial service industry, taxes, grants and even concessional loans may be regarded as politically unviable. In lieu of publicly sourced mitigation finance requested by developing country Parties, the U.S. and European financial services industry, recapitalized by the U.S. Federal Reserve Bank with at least USD 29 trillion of emergency concessional rate loans and purchases of "toxic" (unsellable) assets[3], may be in the strongest position to buy GSBs and trade the carbon credit collateral posted to receive the bond funds.

All Parties would benefit by a vigorous discussion about GSB design, the regulation of the financial markets in which the bonds and their carbon emissions credit collateral would be traded, and the oversight of the bond's financial and environmental performance. IATP has published its views on a GSB proposal by the International Emissions Trading Association and will not repeat those views here.[4] However, Parties and observers should analyze this proposal and similar ones that require developing country carbon credits as green bond collateral, in view of the design and mitigation performance of carbon markets.[5] Particularly insofar as developing country Parties could incur substantial amounts of green bond debt that could greatly exceed any offset credit revenues generated under an NMM, it is crucial that the LCA scrutinize not just the various proposed legal definitions of the NMM, but the financial tools proposed to implement the NMM. This discussion should take place in the workshops requested in paragraph 80 of the LCA chair's conclusions.

The New Market Mechanisms debate among the Parties

A survey of the LCA discussion of a NMM reveals a sometimes bewildering and conflicted diversity of carbon emissions trading and/or crediting schemes that could be counted within an eventual UNFCCC definition of an NMM.[6] The NMM is "new" in the sense that the proposed trading schemes either would complement or subsume the project-based old market mechanism, particularly the Clean Development Mechanism. The CDM has produced too few, or too many and fraudulent, offset credits for a few developing countries, depending on your view of the CDM's performance. Some proposals for a NMM definition would include a trading mechanism that continues to issue emissions permits freely to emitting industries prior to achieving any reduction targets, as do current Emissions Trading Schemes.

Additionally, the NMM may include a sectoral crediting system that would reward economic sectors, e.g. the cement industry, with ex-post emissions credits after the Monitoring, Reporting and Verification of whether a specific sector in a Party has exceeded greenhouse gas reductions relative to a predetermined sectoral emissions reduction baseline. Sectoral crediting lightens the burden of showing that a specific project has resulted in an emissions reduction by increasing emissions accounting flexibilities. If CDM projects fail to meet emissions reductions targets, they can nevertheless "succeed" within a sectoral crediting scheme, through the averaging of failed and successful project emission reductions, relative to the all-important negotiated baseline.

We share the belief that the "scaling up" of carbon offsetting through sectoral programs (and a reformed CDM) would promote "double counting", with industrialized countries outsourcing their responsibilities for reducing greenhouse gas emissions, then claiming a significant proportion of the finances that flow through such projects as "climate financing."[7] It is unlikely that developing country Party warnings to the LCA against such "double counting" will be heeded by Parties who are counting on "cost effective" offsets to allow their corporations to meet best endeavor emissions reductions targets while maintaining a competitive advantage in trade.

In addition to the proposed NMM trading and crediting schemes, there are other elements proposed for inclusion in the NMM definition, e.g. an Ecuadoran proposal for Net Avoided Emissions. However, we expect proposals that do not increase flexibilities to create and trade offset credits will be ignored in the WTO Green Room-like process that increasingly dominates UNFCCC decision making and drafting.[8] In sum, the crediting and trading elements proposed for inclusion in an NMM definition reflect a desire by some Parties to legitimate within the UNFCCC existing carbon emissions trading schemes and expand offset crediting practices to provide developed country industries with yet more flexibilities to meet the best endeavor targets of the Copenhagen Accord.

Two governance issues

There is a wide variance of opinion among Parties about whether the governance of an NMM would be primarily that of the UNFCCC, otherwise international, or domestically governed. In our view, the effective governance of the NMM may be determined for many developing country Parties by agencies well outside the control of the UNFCCC. To be sure, the CoP decided to "designate the Green Climate Fund as an operating entity of the Financial Mechanism of the Convention" and decided further that the "Fund will be guided by the principles and provisions of the Convention."[9] However the Green Climate Fund is just one of potentially several financing venues for mitigation projects under the NMM, including bilateral donors, the World Bank BioCarbon Fund and the Bank's Climate Investment Funds, if they are not phased out after the GCF begins to operate.

Furthermore, the CoP decision "to launch a process to develop a protocol, another legal instrument or an agreed outcome with legal force under the Convention applicable to all Parties"[10] by 2015 does not mention such UNFCCC foundational principles as equity, historical responsibility and common but differentiated responsibility. Hence it is difficult to know by what principles the Fund or any other operational entity of the Financial Mechanisms will be governed, once it is capitalized. The United States is pleased that its principle of "legal symmetry" of obligations among developing and developed countries has been incorporated in the decision to negotiate a new protocol. It is presumably pleased that the aforementioned Framework principles will not be a basis for negotiating the post-Kyoto protocol.[11]

Questions for the LCA about green sectoral bond financing of NMM projects

The following questions are developed on the basis of two assumptions: 1) even if a sectoral crediting scheme is adopted under the NMM definition, mitigation finance will continue to be project based, i.e. projects within the framework of a Nationally Appropriate Mitigations Action plan will be financed, not an entire NAMA; 2) even if the environmental performance of GSBs is evaluated according to a sectoral crediting scheme, that performance will still be the net mitigation result of the projects financed by the bond.

1) Which international entity will design the terms of reference for the green sectoral bonds and determine under what conditions and when can the carbon credit collateral for the bond be redeemed by the developing country Party bond issuer, not just as a result of paying off the bond's principle and interest but also satisfying the bond's environmental performance? The Green Climate Fund Board? If not the Board, what jurisdiction would the CoP have over any operational entity not under the principles of the UNFCCC?
2) Who will determine the volume and value of carbon credits that developing country Parties would post as collateral to the buyers of the green sectoral bonds?
3) If the projects funded under a green sectoral bond failed to meet emissions reduction targets, even under sectoral crediting schemes, would developing country Parties have to surrender the carbon credits to the bond purchasers?
4) If developing country Parties defaulted on their interest and principal payments to bond creditors, under what conditions would be they be allowed to issue new green sectoral bonds?
5) If developing country Parties decide that the terms of the GSB oversight body (the Green Climate Fund or the "bespoke body" that IETA calls for) are too onerous to use for mitigation finance, and mitigation finance from developed country Party public sources is not forthcoming, what other financing options do developing countries have, whether to meet their mitigation obligations under a new operational protocol or to finance emissions offset projects?

Conclusion

Developing country Parties have repeatedly stated their preference for public finance to provide the great majority of mitigation and adaptation finance, believing it to be more reliable, predictable and easier to monitor and verify than disparate private sector financing of mitigation projects. (There is little private sector investment in adaptation, as adaptation is judged to be non-remunerative for private sector firms.[12]) Developed country Parties, having elided the principles of equity, historical responsibility and common but differentiated responsibility in the Durban Platform terms of reference, may believe that diplomatic arts can oblige developing country Parties to both provide a new cheap commodity, offset credits for developed country Parties under the NMM, and to pay for bonds to do so.

However, given the poor market and environmental performance of carbon markets so far, we do not believe that an accounting arrangement to give major emitters yet more flexibility to meet a voluntary emissions reduction from a self-selected baseline will have a mitigation effect sufficient to reduce loss and damage significantly. The LCA should not adopt an NMM definition until it agrees on the design and oversight of financing tools to be used under the aegis of the Green Climate Fund and other operational entities of the Financial Mechanism.

Respectfully submitted by Dr. Steven Suppan on behalf of the Institute for Agriculture and Trade Policy (IATP).

[1] E.g. "Green Bond Factsheet," World Bank, July 26, 2011.
http://treasury.worldbank.org/cmd/pdf/WorldBank_GreenBondFactsheet.pdf
[2] "Report of the Secretary General's High Level Advisory Group on Climate Change Financing," November 5, 2010, 6.
http://www.un.org/wcm/webdav/site/climatechange/shared/Documents/AGF_reports/AGF%20Report.pdf.
[3] James Felkerson, "$29,000,000,000,000: A Detailed Look at the Fed's Bailout by Facility and Recipient," Levy Economics Institute, Working Paper NO. 698, December 2011. http://www.levyinstitute.org
[4] Steve Suppan, "The New Climate Debt: Carbon Trading Wrapped in a Green Bond Proposal," Institute for Agriculture and Trade Policy, November 30, 2010. http://www.iatp.org/files/451_2_107885.pdf
[5] See our March 5 comment for the LCA on market mechanisms.
[6] "New market mechanisms in charts: Version 1.0," Institute of Global Environmental Strategies, Government of Japan, September 2011. http://enviroscope.iges.or.jp/modules/envirolib/upload/3352/attach/new_mech_charts.pdf
[7] Oscar Reyes, "World Bank Partnership for Market Readiness: a critical introduction," Carbon Trade Watch, January 20, 2011. http://www.carbontradewatch.org/articles/world-bank-partnership-for-market-readiness-a-critical-introduction.html
[8] Meena Raman, "Major clash of paradigms in launch of new climate talks," (corrected), Third World Network Climate Update No. 25, December 13, 2011.
[9] "Green Climate Fund – report of the Transitional Committee," Draft decision CP. 17, Conference of the Parties, United Nations Framework Convention on Climate Change, December 10, 2011, paragraphs 3-4.
[10] "Establishment of an Ad Hoc Working Group on the Durban Platform for Enhanced Action," paragraph 2, Conference of the Parties, United Nations Framework Convention on Climate Change, December 10, 2011.
http://unfccc.int/files/meetings/durban_nov_2011/decisions/application/pdf/cop17_durbanplatform.pdf
[11] Pilita Clark, "Climate change, The great regrouping," Financial Times, December 14, 2011.
[12] Barbara Buchner et al, "The Landscape of Climate Finance," Climate Policy Initiative, October 2011, Table 1, 8.
http://climatepolicyinitiative.org/wp-content/uploads/2011/10/The-Landscape-of-Climate-Finance-120120.pdf