New Market Mechanisms & Framework for Various Approaches: Luxury or Necessity?

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The Climate Change World

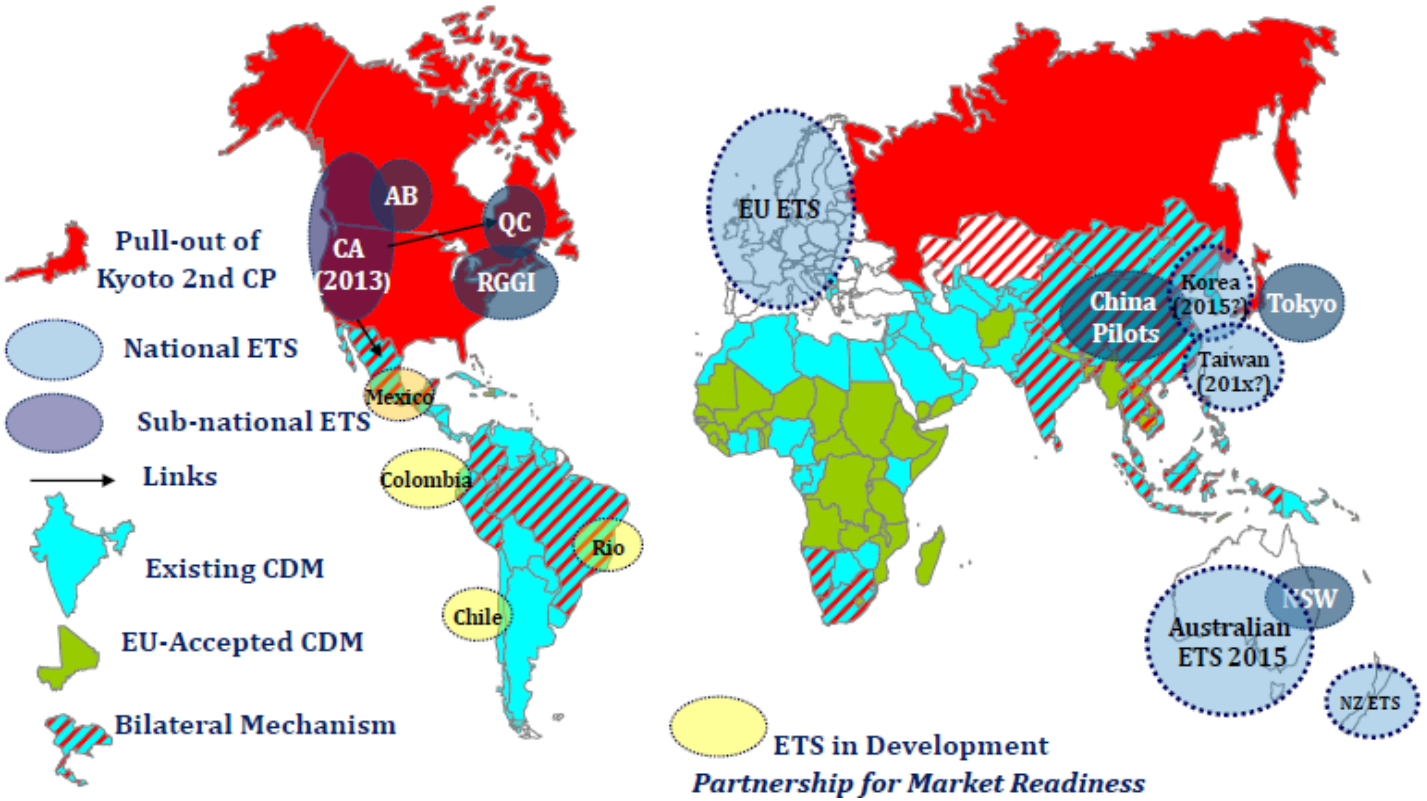
KP1

- Orderly/Cartesian
- All demand/commitments within KP
- AAU/Art 17 underlying any international transfers
- Units used KP units
- Markets delivered more than KP ambition

KP2

- A transition period: KP and Copenhagen/Cancun commitments in parallel
- CDM/UN mechanisms not a monopoly anymore
- Other markets/mechanisms emerging
- Domestically created units could circulate
- AAUs/Art 17 does not always provide linking
- Level of ambition vs. market delivery: unknown

Emissions Trading Developments Worldwide



Source IETA

Carbon Markets/Mitigation Approaches

- **UNFCCC** (under the authority of)
  - CDM
  - JI
  - REDD+
  - NMM
- **Domestic**
  - EU ETS
  - Australia
  - Yasuni
  - BOCM

UNFCCC negotiations : FVA & NMM

Why:

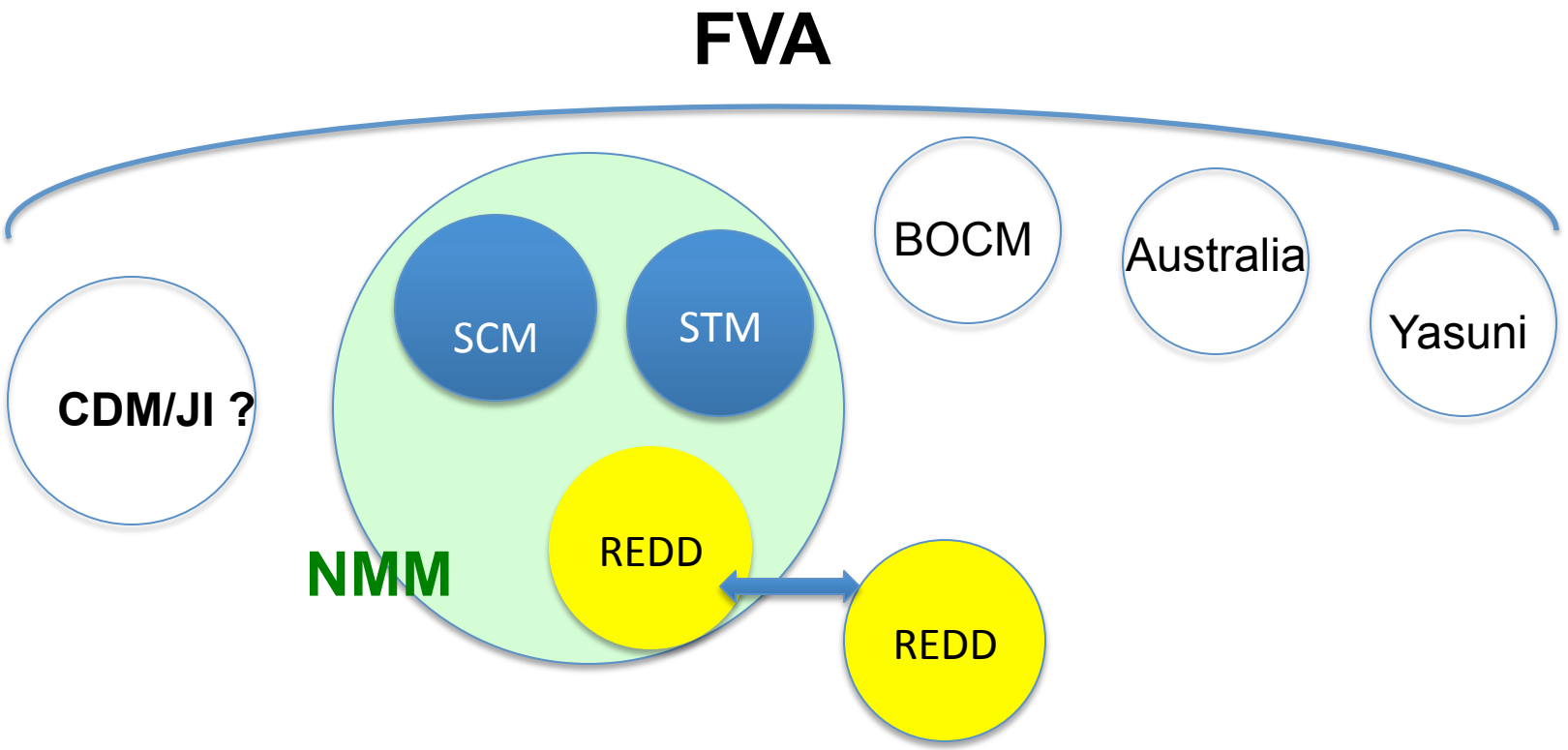
- Bali Road Map
- Adaptation to emerging CC framework/sectoral/net reduct.

Political text: ambiguous

- ? How do they relate – definitions
- ……
- ? Objectives
- ? Functions
- ……
- ? M&P

FVA & NMM

Assumption: A global agreement & UNFCCC directed compliance



Why NMM?

- Increased level of ambition (maybe)
- Transition to new climate change regime
- Net environmental reductions
- Dissatisfaction with CDM
  - Complexity
  - Achieving too little/too much
  - Difficult to turn the ship

New Market Mechanisms

- EU definition
- Sectoral in nature
- Sectoral Trading & Sectoral Crediting
- Under the authority of the COP
- Top down rules
- Room for national implementation

Issues for NMM

- requirements for Party participation;
- who can participate;
- the approaches covered by the NMM;
- sector coverage;
- boundaries;
- methods to determine baselines;
- the determination of crediting thresholds;
- the length of the crediting/trading period;
- the measurement, reporting and verification (MRV) requirements;
- provisions for tracking of units;
- the avoidance of double;
- institutional arrangements, including oversight issues;
- the allocation of reductions between developed and developing countries;
- the rules for permanency;
- share of proceeds;
- rules for supplementarity and the setting of numerical targets;
- recognition of early action;
- treatment of small island developing states (SIDS), least developed countries (LDCs) and vulnerable African countries;
- the transmission of price signals from the aggregate to the individual level;
- issues of sustainability; and
- technology neutrality.

Why do we need an FVA?

- Environmental value vs. monetary value of units
  - Environmental/compliance value set by regulator
  - Monetary value set by the market
- Liquidity
- Linking

FVA

- The FVA is a set of components and rules that will ensure that all approaches used for mitigation will be integrated, and receive recognition for UNFCCC compliance.
- 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.
- NO UNFCCC compliance – FVA become a “safety net”

FVA: Objectives, Scope, Components & Functions

- Integrate national and international units for UNFCCC compliance
- Under the authority of the COP
- Market & non-market approaches/crediting and trading
- Ensure environmental integrity of units used for UNFCCC compliance. There is no definition of environmental integrity.
- That accounting can be done - not an FVA objective or function.
- There is no double-counting

FVA: Objectives, Scope, Components & Functions

Components

- International Compliance Unit (ICU)
- Standards for Environmental Integrity (SEI)
- International Transaction Log (ITL)
- Market Regulatory Board (MRB)
- National Registries (NR)

Defining Environmental Integrity

Despite the central importance of environmental integrity for all market mechanisms, it has not been defined.

Environmental integrity, from UNFCCC discussions:

- **Lead to real, permanent, additional and verified mitigation outcomes,**
- **Avoid double counting,**
- **Achieve a net decrease and/or avoidance of greenhouse gas emissions compared to a predefined and recognised baseline.**
- **The UNFCCC discussion is focused on crediting**
- **NMM & FVA includes everything: C+T, crediting, REDD+, etc**

Threats to environmental integrity

Permanence	Some programs award credits for actions to increase the amount of carbon sequestered by natural sinks, such as forests and agricultural soils. Once recorded there is a risk that subsequent land use changes are not detected and the release of the sequestered carbon is not recorded.
New Sources and Shutdown	Treatment of new sources (entrants) and exits will affect allocation. The impact on EI depends on the design of the programme.

Cap stringency	The stringency of the cap is critical on the Environmental Integrity of a capped system. The best examples are EU ETS P1 and KP1, where economic collapse led to a large surplus of AAUs – and created a new expression " hot air"
Baseline Setting	The EI of credits systems depends strongly on the correct calculation of the baseline or "business as usual" scenario. A generous one will lead to over-issuance of credits (e.g. CERs) and compromise the system's credibility

Use of intensity targets	Certain programmes do not cap emissions, but focus on the intensity of GHG emissions per unit of output. Such programmes allows overall output to increase and do not guarantee absolute emission reductions. Linking them to markets with absolute caps could transfers that approach to the whole system.
Treatment of additionality	Additionality is fundamental to the crediting system. What qualifies as a project or activity under the system is the first thing that most observers will look at to judge the EI of the system. What has been mostly used has been the project by project CDM approach that has been to so me degree inadequate due to its counterfactual nature. Other systems are now being proposed
Crediting threshold setting	The CDM and other market approaches are moving away from the offsetting principle and towards net emission reductions. A crediting threshold, stricter than the BAU baseline, provides one option for implementing net emissions reductions or ads a level of strictness or conservatism when credits are calculated

Borrowing and banking provisions	Borrowing and banking of allowances/credits allow participants to optimize their compliance strategies over longer time periods. Carbon market and other mechanisms are to some degree still in a learning phase, and allowing banking may allow units that have not gone through the latest and more conservative approaches to stay in the system. Also, it would allow easier produced units to inflate the baseline. However, care must be exercised, as a random banning of banking that had been expected will discredit the regulatory credibility of any carbon market.
Length and renewing of crediting periods	How credible is the baseline given the length of a crediting period ? Are changes allowed during the crediting period depending of the length or at the start of a new crediting period?

Operational rules cont.	
Transparency and public participation	Regulators and those regulated need direct channels of communication, allowing for public input into the system, as well as grievance and appeal processes. The absence of such provisions can lead to a dysfunctional mechanism threatening therefore its EI. This has been amply demonstrated I CDM projects where this has become an issue
MRV	The accuracy of MRV standards in different programmes can affect EI. "A ton is a ton" is a critical element. How this is verified assumes great importance. Some see third party verification as an essential element that needs to be included.
Exchange mechanisms	In a world of bottom up, domestic approaches, and different units (CO2, energy efficiency, renewable certificates, etc.) the setting of CO2e rates becomes critical. How is that accomplished will impact accounting for compliance, etc

Compliance and enforcement regimes	
Independent regulator	Two parties engaged in a transaction have an incentive to inflate baselines. This accusation has often been leveled at JI T1 and is re-surfacing in the BOCM context. It also strongly emerges in the context of the FVA discussions – do units issued domestically, and used for international compliance in a jurisdiction other than the one where they were created need an independent (international) recognition ?

Potential for double counting	
Indirect emissions	Some programmes recognise both direct and indirect emissions reductions. This can lead to double counting, if reductions originating from indirect reductions (e.g. energy savings) are also observed in emission reductions at source (e.g. power station produces less energy thus emits less), this can lead to double counting.

ADDITIONAL QUESTIONS:

- **Is economic efficiency part of the equation? e.g. HFCs – is cost and indication of lack of EI?**
- **Is technology an indicator of EI? (e.g. should coal plants be excluded event if efficient?)**
- **Is the objective real and permanent reductions or efficient use of resources for mitigation?**

Environmental Integrity Index

Should such an index grouping the elements above, as applicable, be defined and applied to projects, markets systems, etc?

FVA: Objectives, Scope, Components & Functions

Functions of the FVA

- Track 1 (T1 - Review & Approval Track)

OR

- Track 2 (T2 - Review & Transparency Track).

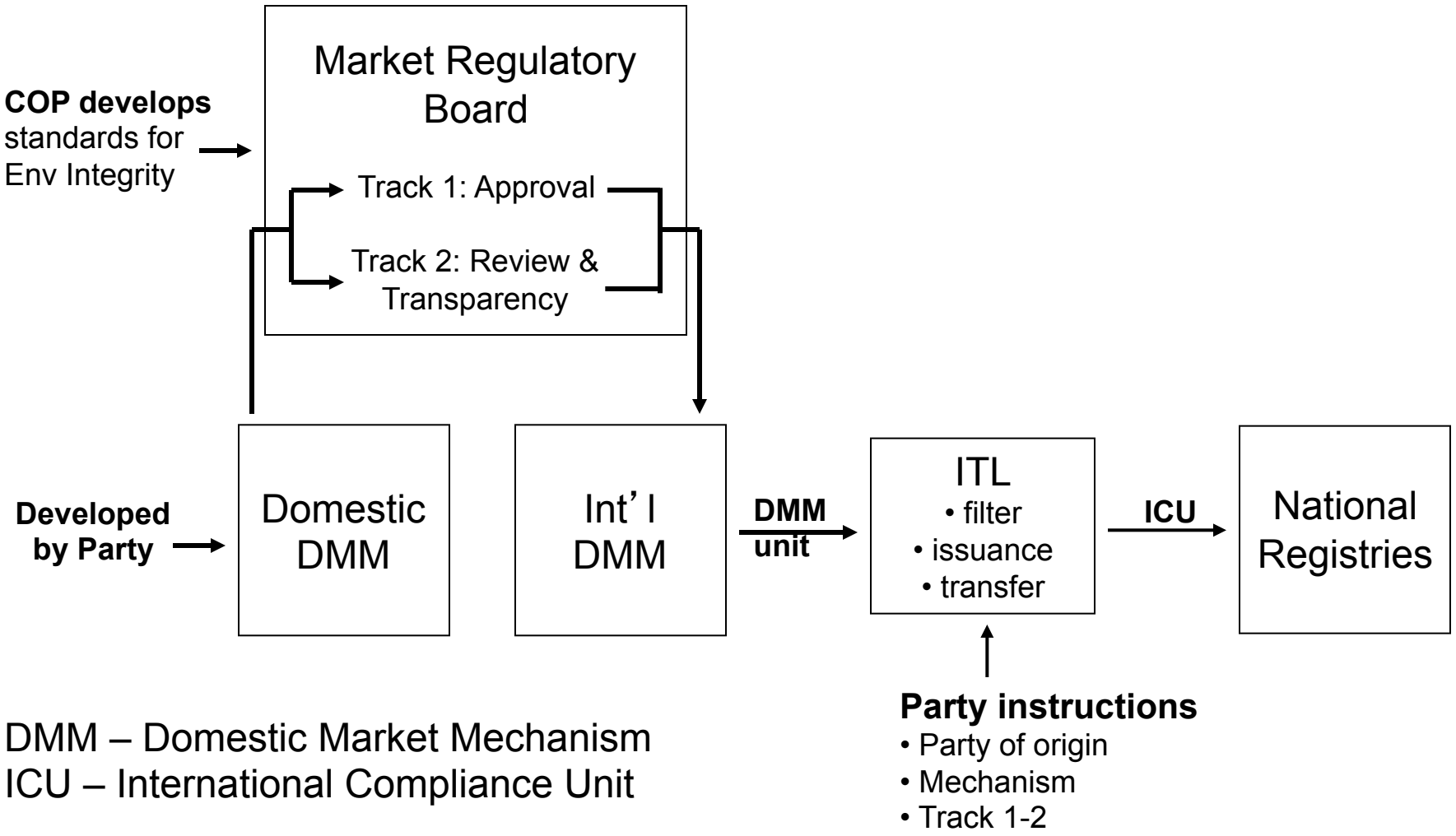
Functions of FVA

Approval Role

A Regulatory Body reviews and approves a Market Mechanism created outside the UN and submitted for approval so units can be used for UNFCCC compliance outside the jurisdiction where created

Transparency Role

Provides for transparency of standards and procedures used in a domestic market mechanism whose units are intended for use with UNFCCC compliance outside the jurisdiction where created



DMM – Domestic Market Mechanism
ICU – International Compliance Unit

What is needed from Doha to move forward?

- Define Objectives
- Define Functions
- Define Scope
- Give mandate to SBSTA to continue work

Current LCA text

- No role for UNFCCC/COP in FVA
- Allows the use of UNITS from domestic and bilateral market mechanisms(e.g. Japanese BOCM) without any international/COP supervision
- No guarantee of environmental integrity
- Promote need for outside approval of developing countries purely domestic various approaches, which have no international implications - why ?
- Confuses role of Framework and NMM

- Definitions for market and non-market approaches
  - Two levels
    - How reductions are produced
      - Market incentives
      - Non market
    - What happens to reductions
      - Traded in the marketplace
      - Not traded