

Recommendations for the efficiency in the operation of the CDM and opportunities for improvement

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CDM Watch welcomes the opportunity to provide its views to the CDM Executive Board on strategic improvements in the operation of the CDM as requested by the CMP in its decision 2/CMP.4.

CDM Watch is very concerned about the development of the CDM over the past years and presents these views in light of the CDM's failure to meet both of its key objectives to support climate change mitigation and sustainable development in developing countries. Highlighting the need to address the poor environmental integrity, little contribution to sustainable development and inequitable geographical distribution of CDM projects, this submission focuses on the following shortcomings:

- (1) Poor environmental integrity of CDM projects
- (2) Little contribution to sustainable development
- (3) Inadequate governance structures of the CDM Executive Board (the Board)
- (4) Lack of transparency in decision-making
- (5) Poor performance of Designated Operational Entities (DOEs)

These five main points are key premises for an efficient operation of the CDM. Given that the CDM has grown to a multi-billion dollar market, the Board is de facto a market regulator. To take on this role, the Board, with its non-permanent members, needs to move to a truly supervisory committee and delegate decisions on individual cases to a professional support structure. The impartiality of Board members needs to be addressed and immunity of Board members needs to be guaranteed. The current processes with regard to the documentation and justification of decisions need to be improved and access of UNFCCC accredited observers to the Board and the DNA Forum needs to be granted. Moreover, lessons learnt from the poor performance of DOEs in the past need to be addressed. Most importantly, the poor environmental integrity and the missing contribution to sustainable development need to be brought back on the agenda.

(1) Poor environmental integrity of CDM projects

The demonstration of additionality is a key requirement to maintain environmental integrity. However, many of the registered projects do not reflect actual reductions in emissions¹. If a CDM project is not additional but nevertheless registered as a CDM project, this results in an increase of global GHG emissions. Yet, there have been considerable problems with the way how the additionality of CDM projects is assessed in practice. Moreover, the inefficient and time consuming practice of additionality testing takes large parts of the limited time of the Board and adds considerable time, cost and uncertainty to the CDM application process. The enormous number of current CDM projects in the pipeline where additionality is questionable as well as the likelihood of the mechanism to continue to play an important role in a post-2012 regime, indicate the importance of improving the environmental integrity of the CDM. While urgent action is needed, it needs to be recognized that problems of additionality testing cannot be completely solved. Alternative approaches to safeguard the environmental integrity and to create net-atmospheric benefits of the CDM need to be addressed when discussing the role of the CDM in a post-2012 climate regime.

¹ - Lambert Schneider, Öko Institut (2007). *Is the CDM fulfilling its environmental and sustainable development objectives? An evaluation of the CDM and options for improvement*: "roughly 40% of the projects that were registered from the start of the CDM until July 2007 the additionality is unlikely or questionable."; Wara MW, Victor DG. (2008). *A realistic policy on international carbon offsets. Rep. PESD Working Paper #74, Program on Energy and Sustainable Development, Stanford University, Stanford, CA*: "the assumption that it is possible to administer an offsets system so that it rewards only bona fide reductions... is valid for only a fraction of the real offsets market."; International Emissions Trading Association (IETA 2005) in a position paper for COP/MOP1: "Proving intent is an almost impossible task that is clear-cut only in rare cases (...) Business perception is that in its current form the test for additionality (...) exposes every project to a highly subjective assessment of its CDM eligibility and allows for second-guessing by the EB."

(2) Little contribution to sustainable development

The CDM has two objectives – achieving cost-effective emission reductions and achieving sustainable development in the host countries. Different from other provisions under the CDM, the assessment whether a CDM project contributes to sustainable development is the prerogative of the host country government and not under the supervision of the CDM Executive Board. However, the current market mechanism only gives monetary value to emission reductions. This has resulted in a trade-off between the two objectives, with cheap emission reductions being preferred over projects with high sustainable development benefits. Under the current scheme, host countries do not have incentives to reject projects with fewer sustainable development benefits as this lowers their revenues and overall market share. In order to direct investments to projects that contribute to sustainable development, market value is necessary.

(3) Inadequate governance structures of the Board

Annex to decision 3/CMP.1 paragraph 8 (f) requests “*members, including alternate members, of the Executive Board shall have no pecuniary or financial interest in any aspect of a CDM project activity or any designated operational entity.*” Therefore, members of the Board must confirm that they do not have any interest in any project or operational entity at the beginning of each meeting. However, Board members often play multiple roles at the same time, including UNFCCC negotiators, representing their countries’ DNA or managers of large government CDM purchasing programmes. Although members should act as independent entities there are severe concerns about conflicts of interests of Board members², a conflict of interest is only noted in 4 out of 46 meeting reports of the Board. Yet a study³ has shown that membership of the country involved in the Board raises the chances for a project to be approved. Moreover, Board members do not have diplomatic immunity and therefore risk prosecution or lawsuits on the basis of their decisions. CDM Watch believes that a global carbon market mechanism should not be regulated in this way.

(4) Lack of transparency in decision-making

According to Decision 3/CMP.1, paragraph 16, meetings of the Board “*shall be open to attendance, as observers, by all Parties and by all UNFCCC accredited observers and stakeholders, except where otherwise decided by the Executive Board.*” However, due to a rising number of discussions on individual cases, large parts of the meetings of the Board take place behind closed doors. As a consequence, the reasoning for case decisions on the registration of projects can hardly be reconstructed in meeting reports of the Board. Often, decisions taken by the Board are not clearly substantiated which adds another difficulty to the interpretation of Board decisions. Moreover, the current catalogue does not show whether new decisions by the Board overrule former decisions. Due to the large number of individual case decisions, only limited time is spent on general policy issues and also the revisions of methodologies with perverse incentives are being delayed. The Board, with its non-permanent members, needs to move to a truly impartial supervisory committee and delegate decisions on individual cases to a professional support structure.

(5) Poor performance by Designated Operational Entities (DOEs)

Another serious concern is the performance of Designated Operational Entities (DOEs). The outcome of several spot checks by the Board and the high number of reviews and rejections of projects by the Board suggest that the current system in which DOEs have the main responsibility to ensuring the integrity of the mechanism has failed. Until April 2009, out of the 1596 projects that were submitted to the Board, 17% of projects that were validated positively by a DOE triggered a review by the Board, with the Board rejecting about 40% of the projects that it reviewed. The expectation was that the Board would only intervene in exceptional cases and that DOEs would have the main responsibility for ensuring that CDM projects meet all requirements. Instead, the Board is currently overwhelmed with 129 problematic project activities for which either a review is requested (25), a correction is requested (73) or the project is currently under review (31). Another 71 projects are awaiting registration – if no review will be requested.

² The New York Times (April 2009). *Secretive U.N. board awards lucrative credits with few rules barring conflicts*

³ Florens Flues, Axel Michaelowa, Katja Michaelowa (2008). *UN approval of greenhouse gas emission reduction projects in developing countries: The political economy of the CDM Executive Board*

The solution to these strategic problems as well as to the problems related to the poor environmental integrity and little contribution to sustainable development is to replace or substantially restructure the CDM in the post-2012 regime. In the interim, it is important to limit the negative effects of the CDM and enhance the emission reduction and sustainable development benefits of it. In this light, CDM Watch urges to seriously strengthen the environmental integrity of the CDM and to prioritize projects with high sustainable development benefits. Furthermore, the CDM should not fulfill more than 10% of a country's emission reduction obligation.

Towards this end, CDM Watch requests the Board to make the following **recommendations** to the COP/MOP with regard to the current functioning of the CDM:

(1) The environmental integrity of CDM must be guaranteed

Given the large numbers of non-additional projects currently registering for the CDM, it is essential that much more effective means for filtering out business-as-usual projects be implemented. In the short term, CDM Watch recommends:

- The Board should **publish clear guidance** how the current approaches to assess additionality should be interpreted and validated by DOEs.
- The Board should **apply sanctions to DOEs that do not validate the assessment of additionality** in a critical manner.
- The Board should **encourage methodologies using emission benchmarks to demonstrate additionality** where appropriate in the same manner as recently approved methodology AM0070⁴. Considerations should also take into account geographic and sub-sector specific baselines for certain sectors, such as cement.
- A “**negative**” list should be established for project types that are likely to be non-additional. This negative list should include large hydro power plants since hydropower is a widespread technology that does not need additional support to be built. Moreover, large hydropower projects often have high and sometimes devastating social and environmental costs, which undermine the environmental integrity of the mechanism. Also CDM project types for improving the performance of coal based energy should not be supported.
- **Methodologies** that allow the inclusion of the destruction of industrial gases, such as HFC-23 and N₂O in the CDM need to be **revised to avoid perverse incentives** to maintain high production levels of these gases. The destruction of these gases should continue either through a new methodology that would only issue CERs for a small part of the project activity, i.e. 10%, or through a fund such as the Multilateral Fund under the Montreal Protocol.

While urgent action to improve current additionality testing is needed, it needs to be recognized that the problems with additionality testing cannot be completely solved. Alternative approaches to safeguard environmental integrity when discussing the role of the CDM in a post-2012 climate regime need to be discussed and considerations suggested in recent studies⁵ should be encouraged and taken into account. Furthermore, options for transforming the CDM into a mechanism with net atmospheric benefits should be considered as an approach to further enhance global climate mitigation beyond given targets by industrialized countries.

(2) Contribution to sustainable development must be improved

In order to direct investments to projects that contribute to sustainable development, CDM Watch supports the following approaches:

- **Supporting premium markets**, such as developed by the Gold Standard Foundation where projects with higher benefits for sustainable development can be purchased by buyers of CERs that have an interest in purchasing high quality projects. This can help to give an additional value to sustainable development benefits.

⁴ Approved methodology AM0070: „Manufacturing of energy efficient domestic refrigerators“

⁵ Benito Müller, Oxford Institute for Energy Studies (March 2009). *Additionality in the Clean Development Mechanism Why and What?* Benito Müller, Oxford Institute for Energy Studies, March 2009

- Developing a **methodological standard for assessing the sustainable development benefit** of CDM projects to be agreed at UNFCCC level.
- Developing a **positive list for project types that are regarded to have higher benefits** for sustainable development to receive some form of preferential treatment. This list could e.g. include demand-side energy efficiency and renewable energy generation and exclude hydropower and industrial gas projects.
- **Discounting of CERs from projects with less sustainable development benefits.** This would give projects with higher benefits a higher market value and consequently change the project portfolio due to reduced supply from less sustainable projects.
- Annex I countries could commit to purchase a **minimum quota of projects with high sustainable benefits** in their portfolio. This would result in two different CER prices, giving a higher market value to CERs with high sustainable development benefits to fulfil the quota.

(3) Urgent measures to avoid any potential conflict of interest and to ensure full immunity of Board members need to be taken

- CDM Watch supports **terms of reference (TOR) for members of the Board** as suggested in the EU submission on the review of the Kyoto Protocol under its Article 9. These TOR would include obligations for EB members to:
 - Declare all financial and pecuniary interests.
 - Resign from any association with a company involved in the CDM.
 - Act as an independent entity and not take instructions from any party or external body.
 - Have at least 5 years of relevant experience in the area of climate change mitigation or the global carbon market.
- CDM Watch also supports that the EB should publish a **“Code of Conduct”** that requires that Board members to publish their CVs, and disclose all financial and professional interests that may impact their impartiality in the case of certain decisions.
- Moreover, CDM Watch believes that the **professionalization** and recruitment of full-time salaried Board members with technical and financial expertise related to the CDM would play another important role in ensuring the independence of Board members. The requirements for those experts, hired as employees of the UNFCCC should exclude individuals who have held a position that involved decision-making on CDM related matters for a defined period before serving on the Board. Additional financial resources should be covered by the levy that is currently being paid for the administrative expenses of the CDM (SOP-Admin).

(4) Transparency and efficiency of decision-making by the Board needs to be improved

- A **systematic catalogue of EB decisions** by the UNFCCC secretariat as requested by COP/MOP needs to be developed. This system should include systematic recording and indexing of decisions by the Board and should clearly identify if new decisions by the Board overrule former decisions. The Board should also decide to improve the transparent publication of decisions related to specific projects, e.g. requests for review including historic statistics. Moreover, a search option on other project participants than host countries at *“Project Search”* should be included so to be able to get an overview about how many and which Annex I countries are involved in which project activities.
- All decisions should be accompanied by a **proper justification** which should be attached to the decision and be made publicly available. This would facilitate a broader understanding of the rationales of EB decisions by all relevant stakeholders.
- In order to provide for transparency in the decision making process, **accredited observers and stakeholders to the UNFCCC** should be permitted at the CDM Designated National Authorities Forum and the annual CDM Joint Coordination Workshop.

- To create more capacity for the Board to deal with policy measures and to take a more supervisory role, **decisions on individual cases should be delegated to the support structure, including the UNFCCC secretariat, working groups and panels.** This could apply to the registration, review and rejection of projects, the decisions on issuance of CERs, the accreditation or suspension of accreditation of DOEs and the approval, revision, rejection or withdrawal of baseline and monitoring methodologies.
- The Board needs to take **urgent action on certain methodologies with perverse incentives.** In particular, the Board needs to address the concerns about significant levels of carbon leakage from adipic acid production shifts from industrialized to developing countries as a result of the CDM as well as similar concerns about the destruction of HFC-23.

(5) Quality of DOEs needs to be improved and sanctions should be applied

- The **UNFCCC secretariat should develop training programs** for the personnel involved in the validation and verification services at DOEs. Eventually the participation in such trainings and the successful completion of exams should become prerequisites for validating projects and verifying emission reductions.
- **DOEs should be selected and paid by the UNFCCC secretariat.** This would avoid the current conflict of interests that DOEs are serving the Board but are paid by the project participants. To cover these costs, the UNFCCC secretariat should directly charge the project participants a validation fee. Thus the validation and verification would still be financed by the project participants, but the DOEs would be contracted by and be accountable to the UNFCCC secretariat. A DOE should then be selected via bidding process that takes into account the experience of the DOE with the specific project type and the previous performance of the DOE.
- While CDM Watch welcomed the suspension of DNV in December 2008, a **wider set of sanctions should be developed.** This would provide incentives for DOEs to implement internal procedures that ensure that validations and verifications are undertaken as required by the Board. For these sets of sanctions, rigorous criteria are needed. The Board should adopt a “*specific policy framework to address non-compliance issues by DOEs in a systematic manner*” as announced in its 33rd meeting report, paragraph 12. Sanctions should foresee that:
 - A DOE should be suspended automatically if it has failed three times to meet a key requirement of the CDM.
 - A spot check at the DOE should be triggered automatically if two reviews have been requested by the Board.
 - The Board should also introduce financial penalties for DOEs if they fail to meet requirements (i.e. the correct application of the Verification and Validation Manual (VVM)).
- **Liability for DOEs needs to be strengthened** in cases where CERs are issued in excess if non-conformities in the validation or verification process are detected after the registration of the project or after the issuance of CERs. In this case, DOEs should have a general obligation to replace the CERs issued in excess.

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Established in April 2009, CDM Watch is a joint initiative by several NGOs from Annex I and Non-Annex 1 countries⁶. CDM Watch monitors the Clean Development Mechanism (CDM) with the aim of improving the greenhouse gas and sustainable development benefits of the CDM while preventing its negative impacts. For more information, contact eva.filzmoser@cdm-watch.org.

⁶ Both ENDS, The Netherlands / Centre for Science and Environment, India / Laya Resource Center, India / Evangelischer Entwicklungsdienst - EED, Germany / Federação de Órgão para a Assistência Social e Educacional-FASE, Brazil / Forum of Collective Forms of Cooperation - FCFC, India / Forum Umwelt & Entwicklung, Germany / Germanwatch, Germany / International Rivers, USA / Noé 21, Switzerland / WWF Germany and WWF Japan