NEWSLETTER

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SCRUTINISING CARBON MARKETS

Dear friends,

We are proud to present this first edition of the Carbon Market Watch Newsletter. Carbon Market Watch will continue the activities of CDM Watch and expand further to other carbon market initiatives. In that spirit, we look forward to new endeavors. There is plenty to watch on the horizon!

Eyes are turning towards Qatar, where close to 200 countries will negotiate future climate deals at COP-18. It is unclear if countries will agree to a second commitment period under the Kyoto Protocol. The decision will largely dependent on how to deal with the gigantic 13 billion surplus of Kyoto emission permits. Also decisions on the future of the CDM, JI and new market mechanisms are expected.

Before the start of COP-18, the CDM Executive Board will meet for the 70th time. After a series of astonishingly bad decisions at their last meeting (including reinstating new coal power plants in the CDM) Carbon Market Watch calls on Board members to roll up their sleeves and make bold decisions to cut down the number of fake offset credits.

Evidence is increasing that the CDM is riddled with non-additional projects. According to new research commissioned by the high-level panel on the CDM policy dialogue, CDM offset credits from non-additional and over-credited projects could add up to 3.6 billion tonnes of CO_2 globally by 2020 to the atmosphere. Countries have taken action: South Korea has announced that it will not allow CDM offset credits until 2020. New Zealand recently announced that amongst others, it will ban offset credits from large hydro projects. (Unfortunately this good news is severely dampened by NZ announcing that they will not join a second commitment period under the Kyoto protocol.)

The EU has yet to take action. Despite figures in the "State of the European carbon market" published this week that show that international offsets account for at least ¾ of the overall surplus in the EU ETS, no measures have been announced yet. Clearly, action is needed!

Giving in to international pressure, the EU has unfortunately decided this week to suspend the inclusion of aviation into the EU ETS to encourage the UN's International Civil Aviation Organisation (ICAO) Council to deliver a global mechanism by September 2013. A guest article explains what the chances are for such an ICAO decision and what role global offsetting might play.

Happy reading! *The Carbon Market Watch Team*

CARBON MARKET WATCH @ WORK

Publications

Press Releases

- Press Release: New study shows loopholes could nullify climate commitments (02.08.2012)
- Press Release: CDM High Level Panel's recommendations do not deliver (10.09.2012)
- Press Release: New study shows Kyoto Protocol surplus of emission permits threatens future climate deal (13.09.2012)
- Press Release: Against Own Technical Advice, UN decides to subsidize, remove safeguards, for dirty coal power plants (13.09.2012)
- Press Release: Environmental groups call on EU Ministers to eliminate 'hot air' pollution permits to save a future climate deal (24.10.2012)
- Press Statement: EU Member States fail to agree on eliminating 13 billion Kyoto surplus, squander opportunity for real climate action (26.10.2012)
- Press Release: International offsets undermine European climate goals (14.11.2012)

Policy Briefs and Studies

- CDM Watch and CCAP Policy Brief: The Phantom Menace: An introduction to the Kyoto Protocol Allowances surplus (07.2012)
- G-77 and China proposal on the carry-over rules of Kyoto surplus units from the first commitment period (08.2012)
- New Study: Carry-Over of AAUs from CP1 to CP2 – Future Implications for the Climate Regime (10.2012)

Submissions and Public Inputs

- Comment on the Project Design Document and Application for Validation Rangit II Hydro Electric Power Project, India (23.07.2012)
- UN Body decision marks end for dirty carbon credits from coal power in the EU emissions trading scheme (29.07.2012)
- CDM Watch response to call for public inputs on sustainable development co-benefits (10.08.2012)
- Submission to the CDM voluntary Sustainable Development tool (13.08.2012)
- Comments on Validation of Nallakonda Wind Power Large Scale CDM Project, India (29.08.2012)
- Submission to call for input: CDM Executive Board 69th Meeting Agenda (02.09.2012)
- Open Letter: Environment Council must tackle gigantic kyoto-unit surplus (04.10.2012)
- Submission to call for input: Draft standard for validation and verification of CDM project activities using standardized baselines (08.10.2012)
- Submission to call for input on the draft "Procedure for the development, revision and clarification of baseline and monitoring methodologies and methodological tools" (08.10.2012)
- Submission to call for input: Concept note on impact of update of standardized baselines on CDM projects (11.10.2012)
- Submission to call for input: Draft standard for CDM project activities using standardized baselines (12.10.2012)
- Submission to call for input: Draft revised guidelines for completing the proposed new baseline and monitoring methodology form" (version 02.0) (12.10.2012)
- Submission to call for input on the "Draft guidelines for determination of baseline and additionality thresholds for standardized baselines using the performance-penetration approach" (15.10.2012)
- Submission to Call for public inputs on the CDM project standard (23.10.2012)
- Submission to Call for public inputs on the CDM validation and verification standard (23.10.2012)
- Letter to President Barroso: Refrigeration in Revised F-Gas Regulation (31.10.2012)
- Submission to call for input: CDM Executive Board 70th Meeting Agenda (11.11.2012)

Presentations

- Presentation at 5th CDM Roundtable, Bonn (10.08.2012)
- Participation at CEPS Task Force on High Level Panel on CDM Policy Dialogue (14.09.2012)
- Policy Event organized by CDM Watch and hosted by the Permanent Representation of Denmark and The Danish Ministry of Climate, Energy and Building: The Kyoto surplus of emission permits size, impact, solutions (10.10.2012)

Joint NGO letters and submissions

- Statement by CCAP and CDM Watch on the G77 proposal to address AAU surplus (05.09.2012)
- Joint letter with the Clean Shipping Coalition and EIA to the European Commission on the inclusion of HFCs (05.09.2012)
- Joint letter to ICAO Secretary General on a proposal for a global aviation market-based measure (07.11.2012)

Carbon Market Watch @COP18 (11.2012):

- Recommendations for AWG-KP18 15 Nov 2012
- Recommendations to the CMP8 on the CDM 15 Nov 2012
- Recommendations to the SBI-37 on CDM Appeals Procedure 15 Nov 2012
- Recommendations to SBSTA-37 15 Nov 2012

Farewell CDM Watch – Welcome Carbon Market Watch!

After an eventful three years, it is time to say farewell to CDM Watch and welcome Carbon Market Watch! From November 2012 Carbon Market Watch will continue the activities of CDM Watch and expand further to other carbon market initiatives. In the future, Carbon Market Watch will also scrutinise new market mechanisms, mechanisms to reduce emissions from degradation and deforestation (REDD), reforms of the EU-ETS and more. Visit our brand new website at www.carbonmarketwatch.org.

With this Newsletter, we would really like to thank all those who have supported CDM Watch in the past, in one way or the other, and contributed to the many exciting years we've had since CDM Watch was launched in 2009.

Within the first couple of months after CDM Watch started it was flooded with anonymous reports about undue practices related to various CDM projects. Concerns were made about how validators were carrying out their auditing jobs, how project developers were fiddling numbers to pass the additionality tests, and how local stakeholders were deliberately excluded from the stakeholder consultation processes. Actions by CDM Watch didn't go unnoticed. Last year, CDM Watch launched the CDM Watch Network which to date connects more than 600 NGOs and academics in more than 90 countries that share information and concerns about CDM projects and policies. CDM Watch has made the carbon market aware that CDM projects need to address social as well as environmental integrity.

With the support of dedicated environmental activists, CDM Watch brought evidence to light that showed that HFC-23 CDM projects were increasing their emissions to cash in on ever more carbon credits; thereby flooding the markets with cheap industrial gas offset credits. Because of that the European Union will ban these credits from May 2013. CDM Watch has also had an impact on stopping coal power projects from being registered under the CDM. Largely because of lobby efforts by CDM Watch, 10 CDM coal power projects have terminated their validation and no more projects are expected to get registered before the end of the year. As well, steps towards establishing a grievance mechanism and improvements on stakeholder consultation processes are under way.

"Proportionally manpower to impact, CDM Watch has been the most effective lobbyist in the carbon market world."

The time has come for us to transition from CDM Watch to Carbon Market Watch. The aim is to continue the activities of CDM Watch and, at the same time, expand to scrutinise other carbon market initiatives, like new market mechanisms, the EU-ETS and mechanisms to reduce emissions from degradation and deforestation (REDD). Like CDM Watch, Carbon Market Watch will be active at the UN, in Europe and the Global South. We will also increase our outreach to civil society and environmental policy-makers and streamline our communication efforts. We just launched our new website at www.carbonmarketwatch.org. Please visit it and tell us what you think!

A former CDM Executive Board member once said *"Proportionally manpower to impact, CDM Watch has been the most effective lobbyist in the carbon market world"* and that's exactly how we mean to continue our work as Carbon Market Watch. We'd like to thank everyone around the world who has worked hard to fight climate change by improving the social and environmental integrity of the CDM and other carbon market initiatives. CDM Watch's successes have shown that we can make a difference! Let's keep up the good work and proceed on new adventures.

CDM Executive Board – Bad timing for wrong-headed decisions

At its last meeting in September, CDM Executive Board made a series of unfortunate decisions. At their upcoming meeting in Doha they will again discuss a number of important issues. At a time when carbon markets are collapsing due to severe oversupply, the CDM needs to be significantly reformed. Board members need to roll up their sleeves and take bold decisions that dramatically cut down the number of CDM credits from non-additional and over- credited projects.

CER prices have fallen to an all-time low of below EUR 1. The low prices are caused by an over-supply of credits and not enough demand. At their last CDM Executive Board meeting a number of issues were under discussion that could have potentially improved the environmental integrity of the CDM and consequently also cut the number of credits to be generated from certain CDM projects. It is therefore doubly unfortunate that the CDM Executive Board made several decisions that further undermine the environmental and social integrity of the CDM:

› **Refused to consider alternative approaches to additionality**: Last year, Parties in Durban gave the Board the mandate to improve the rules that determine whether a project is considered "additional" (whether it would not have happened without the CDM). There are currently too many large infrastructure projects in the CDM that are clearly not additional (see Bumpy Road to EU ETS Reform). Nevertheless, the Board declined to adopt effective ways to address the fundamental flaws in the way how additionality is demonstrated.

› **Reinstated the methodology that allows new coal power projects to register as CDM projects.** In an unprecedented move, the Board decided to remove safeguards from the rules that were recommended by its technical body, the Methodologies Panel. The rules adopted by the Board are considerably weaker than the version recommended by the Board's technical experts. CDM finance for non-additional dirty carbon credits support the lock-in of emissions-intensive coal power for decades at the expense of the climate. (More on Coal Power Projects here).

› **Kept the weak voluntary rules for sustainable development.** The CDM Board discussed a draft voluntary tool for sustainable development co-benefits. The already weak tool was further weakened by a decision to remove the no-harm section. Instead of requiring No Harm Safeguards that spell out obligations and reflect the full scope of human rights obligations, the tool will now be silent on these issues. At this meeting, they will probably approve the tool as it stands now (see below).

› **Did not agree to improve stakeholder involvement.** The Board discussed recommendations for improvement of the local and global stakeholder consultation processes yet did not adopt any improvements. Instead many Board members argued against much needed clarifications and additional requirements that would ensure that stakeholder consultations are carried out in a meaningful way. They will continue discussing this issue at the upcoming meeting (see below).

IMPORTANT TOPICS AT THE UPCOMING 70TH CDM EXECUTIVE BOARD MEETING

SUSTAINABLE DEVELOPMENT MONITORING

At the upcoming meeting the Board will discuss and potential approve its voluntary sustainable development tool. This tool is designed for project participants to report on the sustainable development goals of a CDM project. However, the absence of monitoring and verification requirements and the voluntary nature of the proposed sustainable development tool undermine the legitimacy of the tool and greatly limit its utility as a reporting tool.

In line with the recommendations of the CDM Policy Dialogue, Carbon Market Watch recommends that the reporting tool is significantly strengthened and made mandatory. A broad work programme should be established to address this issue in a more substantial and effective way.

IMPROVING STAKEHOLDER PARTICIPATION

The CDM Executive Board will continue to discuss recommendations summarized by the secretariat (meeting 69, annex 22) for improvement of the local and global stakeholder consultation processes yet did not adopt any improvements. We have long been raising the issue that CDM stakeholder consultations are too often carried out insufficiently. It is essential to develop clear rules on how to conduct local consultations and establish clear guidelines to enable an independent entity to effectively assess the consultations. Many of the improvements can be accomplished within the existing mandate, as an elaboration or interpretation of the existing rules. For our detailed comments on the proposed stakeholder involvement improvements, download the CDM Watch submission here.

Carbon Market Watch calls on the Board to act swiftly and decisively to implement the proposed changes. The Board should clarify guidelines for how to conduct and how to validate a local stakeholder consultation. It is also important to clarify what the repercussions for a project proponent are when he is not in compliance with the stakeholder requirements. In case the project proponent remains non-compliant, projects should not receive a positive validation and should not be registered. If valid concerns are raised after project registration (e.g. human rights abuses) such projects should be suspended and not be issued any further CER.

STANDARDISED BASELINES HEADING THE WRONG WAY

The CDM Executive Board will further discuss rules for standardised baselines. This rather technical topic is nevertheless highly important. The new rules that have been developed by the UNFCCC Secretariat could seriously undermine the environmental integrity of the CDM. We have repeatedly provided detailed input to the Secretariat and the Board on this topic. Unfortunately to no avail. Moreover, the Methodologies Panel raised alarming comments to the general approach taken on standardised baselines. The panel concludes that "the existing guidelines may not in every case lead to robust standardized baselines" and "recommends to thoroughly revise" them.

Carbon Market Watch **urges the Board not to adopt the proposed standards and guidelines** in its current form. The documents require a thorough and fundamental re-assessment and careful drafting.

The Board should **put the existing "Guidelines for the establishment of sector-specific standardized baselines" on hold** and start a process **to thoroughly revise these guidelines**, in close cooperation with experts in the field, stakeholders, and the Boards panels and working groups.

A **work programme** should be established to enhance standardisation in the additionality tool, the combined tool and relevant baseline and monitoring methodologies.

STOP OVER-CREDITING OF NITRIC ACID PROJECTS

Nitric acid CDM projects destroy N2O, an unwanted by-product in in the process of producing nitric acid. The Methodologies Panel prepared an information note, (57th meeting, annex 5) on N2O abatement from nitric acid production. Their research confirmed our previously voiced concerns that the current methodologies (AM0028, AM0034 and AM0051) provide a perverse incentive to stay with older, less efficient technology. This can lead to inflated baselines which results in the issuance of too many CERs for such projects. The Meth Panel recommends introducing the default emission factors that would remove the perverse incentives.

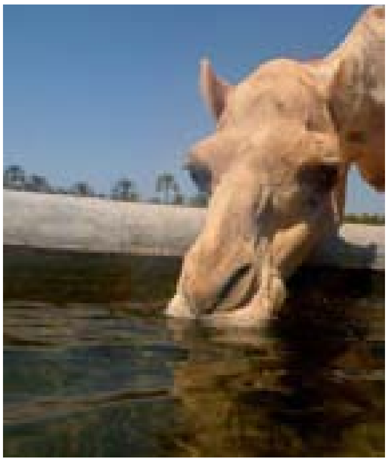
The Board should follow the recommendations of the Meth Panel, to revise the approved methodology AM0028 to limit its applicability to caprolactam plants, to withdraw approved methodologies AM0034 and AM0051 and to revise the methodology ACM0019 to introduce default emission factors for existing plants.

Doha – Negotiating the Future

For two weeks delegates from close to 200 countries will negotiate the future of the planet at COP18 starting on 26 November in Doha, Qatar. Carbon markets will be an important topic in Doha. Decisions on the future of the CDM, the JI, AAU surplus and New Market Mechanisms are at stake.

Carbon markets are in the dumps and the future for the so called "flexible mechanisms" is grim. Prices for offsets from the Clean Development Mechanism (CDM) and from Joint Implementation (JI) have collapsed to below 1 EUR per tonne. The European cap-and-trade system (EU-ETS), the largest such trading mechanism, is so severely oversupplied that -- if the EU does not intervene -- it is unclear if the EU-ETS will survive in any meaningful way. The main reason for this carbon market collapse are the very weak emission reduction targets rich countries have committed to. The targets are higher than emissions are predicted to be if countries just continue on their business-as-usual emissions path. This will create a lot of new "hot air" until 2020.

No wonder carbon markets are collapsing: We don't need them because weak pledges and the economic crisis are reducing emissions for us. But instead of creating employment through renewable energy growth and energy efficiency measures, we are losing jobs and people are struggling to make ends meet in many countries.



Our main message for the climate negotiators In Doha is therefore simple and clear. First and foremost countries must dramatically increase their pledges now to reduce emissions. Otherwise we will not stand a chance to prevent catastrophic effects of climate change.

What will be negotiated in Doha

Parties have yet to decide if there will be a second commitment period (CP2) under the Kyoto Protocol. Many of the technical details still have to be worked out. So far only the EU and a few other small countries have publically stated that they will join CP2. The emissions of those countries accounts for around 11% of global emissions. Australia is still on the fence and New Zealand just recently stated that it will not join CP2. The US, Canada, Japan and Russia have already publically stated that they will not join CP2. If we do get CP2 it will exclude the major emitters and be based on woefully insufficient pledges. It is nevertheless vital that CP2 comes into effect. Otherwise the multilateral process will completely disintegrate which would play into the hands of those countries who are refusing to take any binding action.

> **Our main message for the climate negotiators in Doha is therefore simple and clear. First and foremost countries must dramatically increase their pledges now to reduce emissions.**

The 13 billion Kyoto surplus

The surplus of emissions reduction permits from the first Kyoto commitment period (2008-2012: CP1) is estimated to be **13.1 billion tonnes of CO_2**. Russia (5.8), Ukraine (2.6) and Poland (0.8) are the largest surplus holders, followed by Romania (0.7), the UK (0.5) and Germany (0.5).

At the recent negotiations in Bangkok in August 2012 the G-77 and China presented a promising proposal on how to deal with the surplus. It allows for only limited domestic use of the surplus and does not allow for trading. All left over surplus would need to be cancelled by the end of CP2.

Carbon Market Watch supports the G-77 proposal and is advocating for the EU and other key stakeholders to actively support the elimination of the surplus. (More details in the article "The Phantom Menace"). Above all and more than anything, it is essential to raise ambition and to close loopholes before any new market mechanisms get operationalized in the future.

CDM and JI

Carbon market issues will be negotiated in several of the negotiating tracks in Doha. Parties will give their recommendations about how to continue and reform the CDM and JI.

Countries have not yet decided who should be able to use CDM and JI credits in the next commitment period. Carbon Market Watch advocates that only countries that are joining CP2 should be able to buy or sell such offset credits.

Parties must also take bold and immediate steps to improve the environmental integrity of the CDM. The CDM is projected to generate at least twice as many offset credits than will be needed until 2020. Many of those offset credits will come from projects that would have happened anyway. These non-additional projects not only depress prices, they also fundamentally undermine climate goals. A recent study[1] shows that until 2020 up to 3.6 billion credits could come from such climate damaging projects. Parties will also discuss other important CDM issues, such as rules for carbon capture and storage, forestry projects and an appeals procedure. For Carbon Market Watch's detailed recommendations on the CDM, see this link.

> **We advocate for strictly limiting JI to countries that have taken emissions reduction pledges that are below their 2012 emissions.**

JI allows for offsetting projects in countries that have a reduction obligation under the Kyoto Protocol. JI unfortunately is known for its hundreds of millions of credits from projects that have been implemented anyway, even without JI. JI rules are weak and host countries can issue as many credits as they want. (Ukraine, for example just recently issued another 18 million JI credits). Carbon Market Watch therefore advocates for strictly limiting JI to countries that have taken emissions reduction pledges that are below their 2012 emissions.

New Market Mechanisms

At COP 17 in Durban, South Africa last year, Parties decided to establish a "new market-based mechanism" (NMM) and a "framework for various approaches," (FVA) to create minimum requirements for internationally traded credits from regional systems. On both issues the meetings that took place in the course of 2012 saw little progress. Because Parties strongly disagree about how much oversight and quality control new market mechanisms need, it is highly unlikely that Parties will reach agreement on detailed rules for either issue in Doha.

Carbon Market Watch is a bit puzzled why the EU and some other countries are so keen on establishing new market-based mechanisms when there is no demand for such credits and the EU does not manage to reform its own EU-ETS. Yet, in addition to NMM under the UNFCCC framework numerous national or regional trading systems are being developed independently of the UNFCCC. Parallel mechanisms that can generate and trade carbon credits are problematic because of the risks of double counting and potentially weak quality standards in regional and national systems. To ensure a minimum level of integrity, it is important to establish common FVA standards set at the UNFCCC level for such mechanisms.

Carbon Market Watch will be in Doha to advocate for fair and ambitious climate solutions.

Our recommendations and comments on carbon market related issues at COP 18 can be found here.

The Phantom Menace: How to tackle the 13 billion Kyoto surplus

The gigantic surplus of emissions permits under the Kyoto Protocol threatens the viability of a second commitment period and any future climate deal[1]. The EU has been unable to advocate for a strong solution because of the opposition of Poland. Russia will also push for being able to sell their gigantic surplus. Parties must find a solution in Doha, otherwise full carry-over of these units will be allowed. This would undermine environmental integrity and stifle political progress.

The surplus of emission permits from the first Kyoto commitment period (CP1) is estimated to be **13 billion tonnes of CO_2**. Russia (5.8), Ukraine (2.6) and Poland (0.8) and Romania (0.7) are the largest surplus holders[2].

This so called "hot air" surplus is the result of extremely weak CP1 reduction pledges well above what these countries were projected to emit. "Hot air" therefore does not represent real emissions reduction efforts. Poland, for example committed to a 6% reduction from their 1988 emission levels, despite the fact that in 1997, when the Kyoto targets were set, Poland's emissions were already about 20% below 1988 levels.

How Hot Air is created:

A country has an emissions reduction target for 2020 of minus 10% below its 1990 emissions levels. Yet its emissions are projected to be 15% below its 1990 emissions in 2020. This means the country is committing to being allowed to emit more than it actually will! And this leads to the accumulation of "hot air": left over emission reduction permits due to very weak pledges.

Large surplus-holding countries have nevertheless been firm about keeping the right to sell their surplus of emissions permits. However, because the total surplus is over a thousand times higher than the estimated demand, surplus-holding countries will not be able to earn any significant revenue from the sale of their surplus. Prices for Assigned Amount Units (AAUs) have dropped from 13 EUR in 2008 to less than 0.5 EUR in 2012.

Photograph: zwali/flickr

Even without this surplus from CP1, countries will likely accumulate another surplus of 3 to 10 billion tonnes of CO_2 by 2020. This is because developed countries have made very weak emissions reduction pledges for a second Kyoto commitment period (CP2). Together with lenient rules on the use of offsets, they will

1 The Phantom Menace: An introduction to the Kyoto Protocol Allowances surplus. CDM Watch and CCAP Policy Brief: July 2012.

2 Carry-over of AAUs from CP1 to CP2 –Future Implications for the Climate, by Thomson Reuters Point Carbon, September 2012.

be able to emit 3-10 billion tonnes of CO_2 more than they are projected to emit under business-as-usual emissions projections until 2020.

KYOTO TRADING UNITS

Assigned Amount Units (AAUs) are the tradable emission permit under the Kyoto Protocol. One AAU allows a country to emit 1 tonne of CO_2e. Current Kyoto Protocol rules allow countries to carry over all unused emission allowances into the next commitment period.

Parties are also allowed to carry over emission reduction credits from the Clean Development mechanism (CDM) and Joint Implementation (JI). The carry-over of CDM credits (CERs) and JI credits (ERUs) is limited to up to 2.5% each of the total amount of AAUs a country received for the first commitment period. Carry-over from these offsetting mechanisms could lower actual emission reductions by 2020 by roughly 6%.[6]

Because the pledges for CP2 are so weak, it is unlikely that much of the surplus from CP1 will be used, even if full carry-over was allowed. This is why some have argued that this "hot air" is not really a menace at all. We strongly disagree, and here is why.

WHY ACTION IS NEEDED TO TACKLE THE PHANTOM MENACE

The surplus issue threatens the very existence of a second Kyoto commitment period. Although the EU and a few other countries have stated they will join a CP2 from 2013 onwards, it is far from clear if such a CP2 will actually happen. There are several vital issues that need to be resolved in Doha, including how to deal with the gigantic surplus of emissions permits from CP1. In other words, the surplus issue threatens the very existence of a second Kyoto commitment period.

Yet it is vital that CP2 comes into effect. Otherwise the multilateral process will completely disintegrate. This would play into the hands of those countries that are refusing to take any binding actions. We would lose much of the treaty infrastructure of the Kyoto Protocol. This would not bode well for the new climate treaty that aims to include all countries and that is to be negotiated by 2015 and come into force by 2020. It is difficult to see how developed countries could convince developing countries to commit to meaningful emission cuts under a new climate deal without immediate action from developed countries to significantly raise their reduction pledges and to eliminate 'hot air.'

Last but not least, if countries were to increase their pledges for CP2 and the surplus had not been eliminated, countries could meet their more stringent targets by simply buying more surplus without actually cutting their emissions. This is why higher reduction pledges and the elimination of the surplus have to go hand in hand.

PROPOSED SOLUTIONS

At COP 17 in Doha in November 2012 Parties will need to come to an agreement, if the surplus issue is to be resolved. Either a compromise that would restrict the carry-over of AAUs can be agreed on, or the existing Kyoto rules, which allow for full carry-over will remain in effect.

At the UNFCCC negotiations in Bangkok in August 2012, the G-77 group of countries and China had presented a proposal to effectively contain and minimise the use of these surpluses. It allows for only limited domestic use of the surplus and does not allow for trading. All left over surplus would need to be cancelled by the end of CP2.

SUMMARY OF THE G-77 PROPOSAL

- All CP1 surplus AAUs and Joint Implementations offsets (ERUs) can be carried over into the next period and are placed into a Previous Period Surplus Reserve (PPSR).
- Units in the PPSR cannot be traded and only be used for domestic compliance under certain conditions.
- Parties can use PPSR units for compliance if their emissions are higher than their initial assigned amount (as defined in article 3.7 and 3.8 KP). They can only use as many PPSR units in as far as their emissions exceed the initial assigned amount. In other words, they cannot sell their CP2 units and then use PPSR units for their own compliance.
- The proposal aims to prevent the creation of new surplus from weak pledges for CP2: If a party has an assigned amount that allows, on average, higher emissions than the 2012 emissions, the difference between the CP2 assigned amount and the 2012 emissions times the length of the commitment period is cancelled. Of the Parties with the largest surpluses (Russia, Ukraine, EU) only the EU has a pledge below projections for CP2 and that only if ambition is increased above the 20% target. It is therefore very unlikely, that Russia and Ukraine would use surplus domestically and the EU can only do so if they increase ambition or have emissions above current projections.
- By the end of CP2 the remaining surplus in the PPSR will be canceled. The proposal is currently silent on what will happen to the surplus from the second commitment period.
- The rules for CERs remain as they are under current Kyoto rules: The carry-over of CER is limited to up to 2.5% each of the total amount of AAUs a country received for CP1 (thus before trading and before acquisition of CERs, ERUs, see Decision 13/CMP.1 AMMEX I.15.(b)).

The proposal would likely lead to a very low use of CP1 AAU surplus units because currently pledged targets are very weak. CERs carried over from CP1 would make up the bulk of the surplus used in CP2 (see last bullet). A ball park estimate shows that approximately 1 Giga tonne of CP1 surplus would be used, 800 million of those from CDM credits.

POLAND TEAMS UP WITH THE PHANTOM MENACE

The European Union (EU) has been unable to advocate for a strong solution on the surplus. Environment Ministers from EU Member States met in October to agree on the EU positions for COP18. Despite a heated debate, Member States were unable to agree on a strong and explicit position to address the Kyoto surplus. Several Member States -- Poland as the largest surplus holder in the EU being most adamant -- insisted that there should be no limitation on the carry over or use of the surplus. The final Council statement does not mention the G-77 proposal at all. Not having a clear negotiating position puts the EU at a disadvantage during the upcoming climate negotiations in Doha.

WHAT TO EXPECT IN DOHA

In Doha, Parties opposed to restrictions of the carry over will likely try to water down the G-77 proposal or oppose it. Ways to water down the proposal include removing language referring to the 2012 reference level and removing language about the cancellation of CP1 surplus units in 2020. This is dangerous.

We are now on an emissions path that could lead to warming of 4°C or more[3]. In addition, impacts associated with even 2°C of warming have been revised upwards and are now considered "dangerous" and "extremely dangerous"[4]. A world beyond 2°C will threaten the very existence of civilization as we know it. The urgency and importance of this matter cannot be overemphasized.

CDM WATCH URGES

- ***All countries to significantly increase their emission reduction commitments to ensure the world has a reasonable chance to stay at below 2° Celsius of warming.***
- ***All Annex 1 countries to join a second commitment period under the Kyoto Protocol with reduction commitments that are well below their 2012 emissions.***
- ***Annex B countries to agree to a solution of the surplus issue in line with the G-77 proposal and ensure that:***
  - ***No new "hot air" AAU surplus is accumulated in the second commitment period. To be eligible to use any surplus AAUs, CERs and/or ERUs at all, a Party must have a reduction target for the second commitment period that is lower than its 2012 emissions.***
  - ***The already insufficient pledges are not further weakened through the use of surplus. The use of surplus must be severely restricted. Furthermore, any surplus should only be used for domestic compliance and should not be traded.***
  - ***All surplus is cancelled permanently by the end of the second commitment period.***

3 Betts R., Collins M., Hemming D., Jones C., Lowe J., Sanderson M., (2011). When could global warming reach 4°C? Phil. Trans. R. Soc. A 2011 vol. 369, 1934 p.67-84 doi: 10.1098/rsta.2010.0290

4 Anderson K., Bows A. (2011). Beyond 'dangerous' climate change: emission scenarios for a new world. Phil. Trans. R. Soc. A 2011 vol. 369, 1934 p.20-44, doi: 10.1098/rsta.2010.0290

The real impact of international offsets on the EU ETS over-supply

International offsets account for ¾ of the overall surplus in the EU ETS. The real impact of offset credits becomes clear when looking at the new findings of research papers commissioned by the high-level panel on the CDM policy dialogue. CDM projects could generate up to 3.6 billion spurious offset credits by 2020. Join us and Sandbag to discuss this issue in joint events in London and Brussels. Action is needed!

Currently, the European Emissions Trading Scheme (EU ETS) is estimated to be oversupplied by about 2 billion allowances. Albeit heavily disputed, efforts to address the enormous oversupply in the EU ETS are under way. Yet, the role that international offsets have played in the build-up of the surplus remains unaddressed.

To reduce emissions more cost-effectively, international offsets can be used for compliance in the EU ETS. Quantity limits of international offsets in the second (2008-2012) and third (2012-2020) trading periods were set at about 1,6 billion tonnes each. An international offsets that is used for compliance frees up one allowance that does not need to be used for compliance. This means that international offsets are responsible for about ¾ of the overall surplus in the EU ETS.

Despite the large role of offset credits, the review of the ETS legislation does not include means to address the oversupply due to the import of spurious offset credits. This is worrying if we look at the types of offsets that are used for compliance in the EU ETS. Although the EU has made an important step to ban offset credits from industrial gas projects, new research reveals that more needs to be done when looking at the environmental integrity of international offsets:

Up to 3.6 billion spurious CDM offset credits by 2020

Over the past year, the high-level panel on the CDM policy dialogue analysed the CDM and recently released a series of research papers. A research paper on the CDM's impact, finds that, to a large extent, the assessment of the net mitigation impact of the CDM hinges on judgments regarding the additionality of CDM projects in the power sector, especially wind and hydro, but also natural gas, coal, waste-gas capture and biomass energy power projects. These project types are projected to be the source of over half of the CERs issued by 2020. Researchers have expressed concerns that a substantial portion of these projects should be considered non-additional, leading to a significant net increase in global GHG emissions.

The report finds that under a pessimistic scenario, up to 3.6 billion offset credits could come from business-as-usual projects by 2020. Hydro and wind power projects alone could cause a net emission increase of 1.3 billion CO_2 each.

Fossil fuel CDM projects not consistent with goals of ETS

Currently there are more than 40 coal power projects in the CDM pipeline of which 6 have already been registered. Over the next 10 years they will receive about 90 million undeserved carbon credits. These projects have been registered on the basis of flawed crediting rules and are expected to be severely over-credited. Another 26 projects are currently under validation and can apply for registration any time. Together, they could potentially add another 220 million carbon credits over the next ten years. Despite evidence about non-additionality and over-crediting of these projects, the CDM Executive Board has re-installed new crediting rules for large coal fired power plants at their last CDM Executive Board meeting.

The research paper of the CDM policy dialogue panel comments "unlike renewable power projects, the additional challenge for non-additional fossil fuel projects is that they lock in developing countries to relatively high-carbon growth trajectories".

The danger of non-additional carbon offset needs to be addressed in the debate around the over-supply of the EU ETS. There is ample evidence that the eligibility of large scale power sector CDM projects needs to be re-assessed and ultimately excluded from the EU ETS.

Help or hindrance?

Reforming offsetting rules in European Climate policy

Dear Colleagues,

Sandbag and *Carbon Market Watch* cordially invite you to join them along with other leading experts in the field to discuss the future role of international offsets in the EU emissions trading scheme (ETS).

Over two events in London and Brussels we hope to engender a meaningful discussion into the role of offsets by investigating how international offsets from CDM and JI projects are being used in the EU ETS to date, as well as explore practical options to reform offset usage to maintain the incentives and environmental integrity of Europe's flagship climate policy.

Both events coincide with the launch of Sandbag's "Offsetting in the EU ETS" 2012 report- and related online map which gives a detailed up to date overview of how offsets are being utilised in the EU ETS along with where they are being sourced.

Events:

LONDON, House of Lords, Committee Room A2
19th November 13:00 - 14:30
More information HERE – Register HERE

AND

BRUSSELS, European Parliament, Room A3H1
29th November 13:00 - 14:30

More information HERE – Register HERE

International Aviation and Global Offsetting

Guest article by Bill Hemmings, Transport & Environment

Progress is finally evident at the International Civil Aviation Organisation (ICAO) to develop a global market-based measure (MBM) to address CO_2 emissions from international aviation. With the aviation industry predicting significant growth and relatively high abatement costs, market-based measures are likely to focus on carbon markets. Many ICAO member states and industry seem to favour global mandatory offsetting as the most administratively simple and attractive option. However, inherent problems about offset quality remain unaddressed.

The Kyoto Protocol adopted in 1997, tasked ICAO with limiting and reducing international aviation emissions. ICAO's slow pace, led the European Union (EU) to take action to include aviation in its Emissions Trading Scheme (ETS) from the start of 2012. ICAO's 2010 Assembly has resolved to "*continue to explore the feasibility of a global MBM scheme …and report progress*" to the 2013 Assembly. Early this year a Group of Experts was established to provide technical advice to ICAO's Council on options to address the growing emissions. These have been narrowed down to mandatory offsetting, with the option of linking to a revenue generation mechanism such as a transaction fee on the purchase of offset credits, or a cap-and-trade scheme for aviation that offers open access to the carbon markets and which could also generate revenues. The ICAO Council met mid-November 2012 in Montreal to consider progress towards developing a global market-based measure and agreed on the establishment of a high-level group of policy makers to progress the design choices from a political and policy perspective.

The high-level group will need to address many contentious issues that will have far reaching implications including whether the regulated entity should be states or airlines; whether revenue should be raised from an MBM and if so whether to use it to further in-sector emission reductions or to assist developing countries (e.g. through the Green Fund); whether pure offsetting is environmentally effective; and what the level of ICAO's ambition (reduction targets) should be.

At this point, mandatory global aviation offsetting without revenue generation seems the most favoured option by many ICAO members and by the aviation industry itself. At current prices this option would enable airlines to retire emissions at 90 cents per tonne, or even 50 cents, and thus appear very attractive to airlines. Industry influence has always been considerable in ICAO so there is a real danger that airlines' preference could emerge as the favourite option. In addition the close relationships between airline operators and voluntary carbon market standards, means there is likely to be strong pressure to include Voluntary Emissions Reductions (VERs) in any potential offsetting scheme. Indeed, the concerns surrounding the lack of international verification and fungibility remain unaddressed. It is also not clear how a UN body could recognise VERs for compliance. At the same time, it is highly likely that Clean Development Mechanism (CDM) credits will be deemed eligible for use in these processes, yet concerns about their environmental integrity have not been addressed. Moreover, discounting options (for example requiring 3 credits to offset 1 tonne of CO_2) have yet to even be tabled.

Photograph flickr/angeloangelo

The scale of offsetting required for any substantial environmental impact in the aviation sector will have to be dramatic. Even ICAO weak aspirational goal of keeping emissions from international aviation at 2020 levels will require offsetting the equivalent of 140mt of CO_2 per annum by 2026 and over 450mt per annum by 2036.

The issue of quality of offsets is critical to the perceived effectiveness of ICAO's preferred approach. One can assume that the last thing industry wants is to go through all the trouble of arranging a clean bill of health for all the pollution it creates with its friends in Montreal, only to find that this approach doesn't resonate with the public, and it is subsequently challenged to do more to manage its global emissions. The question of quality and relative effectiveness also needs to be addressed as regards the other ICAO option, that of global emissions trading. In the aviation EU ETS, access to offsets is constrained. Would that also be possible in ICAO? Which option is more environmentally effective – mandatory offsetting or emissions trading?

No matter what the final choice could be, it is equally important to set a stringent cap so that offset allowances are not over-allocated (as we have seen with the EU ETS) and so that offset implementation upholds environmental integrity and effectiveness. It is not by any means just about administrative simplicity, process and cost.

All these are important questions and there aren't many answers just yet. The discussions in ICAO over the next few months will need to be definitive if progress is to be made, and these are not inquiries to be resolved behind closed doors. Fundamental issues like these must be addressed openly in public debate where there are questions of offset quality, quantity and supply, they must be properly investigated and the conclusions tested in public. Many airlines have existing programs and they will require some convincing to give them up. If that proves necessary the process must ensure that this is the result.

Who pays? Lessons from CDM forestry projects for REDD

Forestry projects typically involve local communities and are challenging to implement. When farmers get involved with personal financial liabilities, the question of who bears the financial risk arises especially in cases where revenues from carbon credits do not materialise. A closer look at a CDM forestry project and the underlying rules reveals that if the forestry project does not generate tradable carbon credits, the financial risk lies solely on the marginal farmers.

According to the recent report "State of the Forest Carbon Markets 2012", 451 individual forest carbon projects are currently recorded with several compliance and voluntary carbon markets. In total there are 72 forestry projects in the CDM pipeline. After the infamous Plantar project in Brazil was awarded 4 million carbon offsets earlier this year, a second project received carbon credits in October for restoring vegetation cover to degraded land in Ethiopia.

Yet forestry projects don't come without controversy. Due to non-permanence of emission reductions and the high risk of leakage, forestry projects only receive temporary carbon credits (tCERs) which need to be replaced with "real" and permanent carbon credits at a later stage. Moreover, the establishment of crediting baselines and measurement of reductions is inherently difficult because of the volatile nature of forest carbon and the variety of carbon sinks present in forests. Financial constraints are also important. Even with upfront funding, the investments needed for these projects are typically higher than financial returns from the carbon credits. This is especially the case with credit prices at around 1 Euro each. As a result, only two out of 40 CDM forestry projects have received carbon credits even though they have been registered for many years. The administrative CDM process involves high financial costs and often local communities get involved with personal financial liabilities. Hence, if revenues from carbon credits do not materialize, the matter of who takes financial risk arises.

The World Bank's BioCarbon Fund, which invests in around 20 forest and land-use schemes, has historically been the largest driver of forestry projects in the CDM, including the Plantar and the Humbo project in Ethiopia. The BioCarbon Fund is also financing the so called "JK Papermill project"[5] located in India, in the state of Andhra Pradesh and Orissa. The project, which covers 1.600 ha of land and involves more than 1.500 farmers, was registered in February 2011. During the crediting period from 2004-2034 the annual reduction is estimated at less than 5.000 CERs per year. At a carbon price of 1 Euro each, this would amount to about 150.000 EUR over 30 years. Although the monitoring report for the period of June 2004 to August 2011 has been published, no issuance of credits has been requested to date.

5 Project 4531 : Improving Rural Livelihoods Through Carbon Sequestration By Adopting Environment Friendly Technology based Agroforestry Practices

According to the project design document "the farmers equity contribution is in the form of land and labour supplies in the establishment of tree crops. The resource poor farmers are also contributing their savings as investment in the plantation activity. Accordingly, the beneficiary farmers themselves out of their savings or through loans meet the plantation establishment cost."

The project activity aims to raise tree plantations on farmland that are currently under subsistence culture. It also intends to secure supply of timber wood as raw material to JK Paper Ltd. (JKPL) for paper production. The participating farmers entered into an agreement to plant Eucalyptus and Casuarina in growing cycles of five years to sell the timber to JKPL at market rate and were promised to receive at least 80% of carbon revenues from the annual expected tCERs to supplement their incomes. However, consultations with individual farmers confirm that the financial situation of many have considerably worsened given that they have not been able to pay back loans that were provided to them to buy the seedlings and other supplies needed for the plantation. Reports from the farmers[6] confirm that most who were involved in the project are indebted and are waiting for the promised carbon revenue. However, based on the agreement and current carbon market prices, the farmers would get about 2,4 EUR per year for their efforts, which is hardly enough to pay back the loans they entered to facilitate the project.

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A closer look at this project and the underlying rules reveals that participating companies can easily shift the financial risk of a project to participating local communities and farmers. If the project does not generate tradable carbon credits, the financial risk lies solely on the farmers. Even if carbon credits materialise, the revenue would not stretch to cover the costs they have incurred. This is a serious issue regarding the responsibility of participating entities that put the livelihoods of marginal farmers at risk because of a risky CDM forestry project.

Negative experiences with the CDM have to be taken seriously. There are hundreds of REDD projects under development that are likely to adopt similar rules, templates for contracts and agreements. Strong safeguards are needed to ensure that local communities don't have to shoulder the financial risk of forestry projects. If a project fails, financial sanctions and compensation measures are needed to get the poor 'beneficiaries' out of the indebted situations they then find themselves in. This is the minimum social and financial responsibility the public expects of project participants such as the World Bank's BioCarbon Fund.

Trading off financial risks:

The additionality analysis reveals that the methodology puts financial burden on poor farmers

The methodology applied under this project (AR-AM0004ver.3) requires application of the "Tool for demonstration and assessment of additionality for afforestation and reforestation CDM project activities". The current version of this tool allows project participants to choose either the investment or the barrier analysis as a stand-alone analysis. Underlining the decision, the PDD barely states that "it is neither feasible nor appropriate to undertake investment analysis for this project situation" but does not explain why an investment analysis is not feasible and why it is not appropriate. Since the rules allow for this decision, the validating auditor did not further comment on this decision. The Designated Operational Entity (DOE) confirmed the additionality of the project based on the following barriers:

1. **Institutional barriers**: It is argued that it was necessary to set up the organisation Veda Climate Change Solutions Ltd. to provide institutional support to the numerous farmers participating in this project without which the project would likely not have taken place. The DOE considered it a valid barrier.
2. **Investment barriers**: It is argued that only by providing dedicated access to financing the numerous individual investments and by providing upfront payments in terms of CER revenues to bridge the 5 year span from tree planting to harvesting (after which tCERs could then be issued) such kinds of projects would only be attractive to small farmers. This barrier was accepted by the DOE too.
3. **High transaction costs of sourcing raw material from small and marginal farmers**: The DOE did not consider this barrier as relevant because it is associated with JK Paper Ltd. and not the farmers investing in tree planting.
4. **Technological barriers**: It is argued in the PDD that without technological support (for breeding, planting, harvesting activities) farmers would not invest into such projects. Technical support is anticipated to be provided by the paper mill having a key commercial interest in the project to secure timber wood supply. This barrier was also accepted by the DOE.

6 See for example p. 14 Watch This! NGO Voices on the CDM # 3

CARBON MARKET WATCH

Carbon Market Watch was launched in November 2012 to expand the work of CDM Watch to areas beyond the CDM. Carbon Market Watch provides an independent perspective on carbon market developments and advocates for stronger environmental and social integrity. Carbon Market Watch is based in Brussels, Belgium.

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CARBON MARKET WATCH NETWORK

The **Carbon Market Watch Network** (formerly the CDM Watch Network) connects NGOs and academics from the global North and South to share information and concerns about CDM projects and policies. Its purpose is to strengthen the voice of civil society in the CDM and carbon market developments. Carbon Market Watch Network!

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Support us!

We are very passionate in our work to empower local communities and strengthen the environmental integrity of carbon markets. We work on a shoe-string budget and do much of our activities without funding. If you would like to support us with a financial contribution, we'd greatly appreciate it. Your donation will help us to continue our work.

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