



# NEWSLETTER

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SCRUTINISING CARBON MARKETS

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Happy reading!

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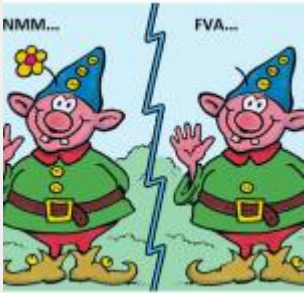
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As you will see in reading our newsletter, we are very passionate in our work to empower local communities and strengthen the environmental integrity of carbon markets. However we work on a shoe-string budget and do much of our activities without funding. If you would like to support us with a financial contribution, [please donate here.](#) Your donation will help us to continue our work.

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# Editorial

Dear Friends,

Carbon Market Watch is happy to introduce you to the new online version of our newsletter.

In this issue, we look at a real hot issue in Doha at COP-18 regarding how countries would deal with the 13 billion left over emission permits from the first Kyoto commitment period. Although we did not get full cancellation of the surplus, the Doha outcome was a success. Parties decided that only a part of the huge amount of 'hot air' can be used until 2020. A clever amendment made to the Kyoto Protocol will also avoid the build-up of new surplus.

On a less positive note, we also look at how Doha left a bitter taste for those hoping for decisions that address the severe quality concerns the CDM is suffering from. Most large scale power supply CDM projects are business-as-usual and therefore undermine the very climate goals the CDM is supposed to achieve. Nevertheless these projects are projected to generate more than half of all credits by 2020. With so many millions of credits from such projects they are set to become the new "HFC-23 challenge" of the future.

Also outlined in this newsletter is how the UNFCCC review of the CDM modalities and procedures, which will take place this year, could be a chance to address some of the quality issues. Parties will decide at COP-19 in Poland what types of reforms the CDM should undergo.

We also discuss how Joint Implementation (JI), the CDM's *little brother*, has grown up very quickly it seems and has turned into a rather destructive adolescent. Although there are 10 times fewer projects in the JI than in the CDM, over the last year millions of JI credits have been issued with very questionable environmental integrity. JI now accounts for one third of all Kyoto carbon credits issued.

The market for CDM and JI has all but collapsed with prices being well below EUR 0.5. At such prices it is impossible to implement and operate additional projects. Nevertheless, both CDM and JI continue to generate millions of credits with very questionable environmental integrity.

Despite severely over-supplied carbon markets and lacking mitigation commitments, countries decided at COP-18 in Doha to establish work programmes to implement New Market Mechanisms (NMM) and a Framework for Various Approaches (FVA) to link regional carbon markets. Yet the scope, aim and future of both the NMM and the FVA remain unclear and dubious.

Meanwhile, the European Emissions Trading Scheme (EU-ETS) has experienced severe price decay because of an oversupply of allowances and credits on the market. As such, European policy makers have been trying to address the oversupply of around 2 billion. Last week, the Environment Committee in the European Parliament voted in favour of the European Commission's 'back-loading' plan to temporarily set-aside 900 million emission allowances from the carbon market. While this is a temporary measure in the right direction, deep structural measures are needed if the EU-ETS is to function as a policy instrument that supports long term de-carbonisation.

We also take a look at how the European Parliament voted in favor of the so called "stop the clock" proposal that puts pressure on the International Civil Aviation Organization (ICAO) to advance progress for a global deal to address emissions from international aviation.

Finally, we provide an overview about developments around forestry emissions and how these could be tackled.

Happy reading!

# Carbon Market Watch @ Work

## Publications

### Press Releases

- [Press Statement: Aviation ETS vote in ENVI Committee](#) (26.02.2013)
- [Press Statement: Carbon Market Watch view on 'backloading' proposal](#)(19.02.2013)

### Policy Briefs and Studies

- [Policy Brief: Doha decisions on the Kyoto surplus explained](#) (04.03.2013)
- [ICAO briefing note: Carbon Offsetting – Do's and Don'ts](#) (21.02.2013)

### Submissions and Public Inputs

- [EC Consultation on structural options to strengthen the EU Emissions Trading System](#)(28.02.2013)
- [Input to CAN submission on EC structural measures](#)(28.02.2013)
- [Submission to call for input: CDM Executive Board 72th Meeting Agenda](#) (24.02.2013)
- [Submission to call for input: CDM Executive Board 72nd Meeting Agenda](#) (23.02.2013)
- [CAN's Submission on Joint Implementation](#) (18.02.2013)
- [Submission on Joint Implementation guidelines and revision \(CAN-International\)](#) (15.02.2013)
- [Letter to JI project Verifier on Waste Heap Dismantling Project in Sverdlovsk, Ukraine](#)(24.01.2013)
- [Open letter to Environment Ministers and delegates of all UNFCCC Parties: Increase ambition and close loopholes at COP18](#) (28.11.2012)
- [Recommendations to the CMP8 on Joint Implementation](#) (21.11.2012)

## Carbon Market Watch @COP18

- [Carbon Market Watch Analysis COP-18: We won a game of poker on the Titanic!](#) (21.12.2012)

## Events

- [European Parliament Event: Help or hindrance? Reforming offsetting rules in European Climate policy](#) (29.11.2012)
- [Carbon Market Watch COP18 Event – Transitioning Away From Large Scale Power Plants Projects To Fix CDM? Buyers Beware!](#) (28.11.2012)
- [COP18 Side Event – Conquering the Phantom Menace: Solutions to the Kyoto Surplus](#) (27.11.2012)
- [COP18 Side Event – Luxury of necessity: A Framework for Various Approaches \(FVA\) under UNFCCC](#) (27.11.2012)
- [UK House of Lords Event: Help or hindrance? Reforming offsetting rules in European Climate policy](#) (19.11.2012)

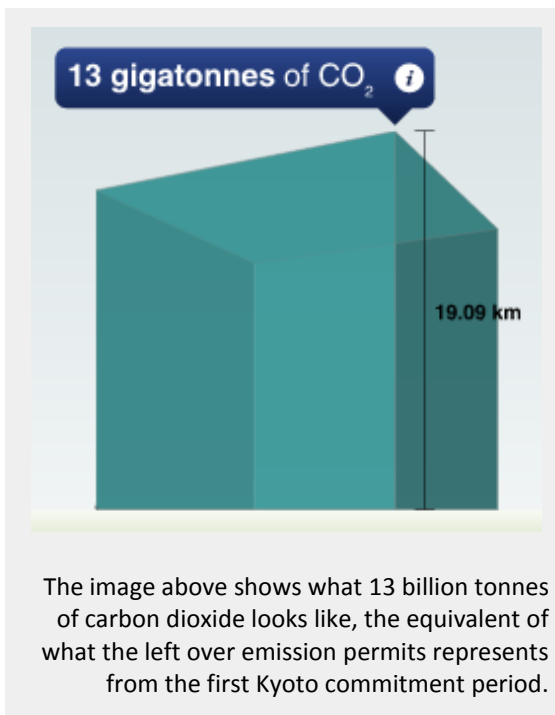
# Doha on AAUs: The Future of the Phantom Menace

*A real hot issue in Doha at COP18 was how countries would deal with the 13 billion left over emission permits from the first Kyoto commitment period. After tense negotiations, countries decided to restrict how much of this surplus can be used for compliance with emission reduction targets. With the aim to avoid the build-up of new surplus, countries also decided to restrict the number of emission permits a country can use for the second Kyoto commitment period. This decision was heavily contested by Russia, Ukraine, Belarus and Kazakhstan because it essentially makes it impossible for countries to accumulate new 'hot air' by choosing a weak target.*

Assigned Amount Units (AAUs) are the tradable emission permits under the Kyoto Protocol. One AAU allows a country to emit 1 tonne of carbon dioxide equivalent (CO<sub>2</sub>e). Existing Kyoto Protocol rules allow countries to carry over all unused emission allowances into the next commitment period.

The AAU surplus from the first Kyoto commitment period (2008-2012) is estimated to be over 13 billion tonnes of CO<sub>2</sub>. This surplus is owned mostly by countries of the former Soviet bloc. 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). ([Point Carbon, 2012](#))

This AAU surplus is often called 'hot air' because it is the result of accounting dealings and not actual emissions reductions. Because former Soviet countries chose very weak reduction targets under the first commitment period it has meant they received millions of these AAUs they did not need. This is why they own most of the surplus AAUs. In Doha these countries made it very clear that they wanted to keep their 'hot air' and use it in the new commitment period either for their own commitments or to sell the permits. Yet if the 13 billion surplus was fully used, countries with a Kyoto reduction target would basically not need to do anything to protect the climate until 2026 and would still, on paper at least, meet their targets (for more on this see a recent [analysis by Climate Analytics](#)).



The image above shows what 13 billion tonnes of carbon dioxide looks like, the equivalent of what the left over emission permits represents from the first Kyoto commitment period.

*If the 13 billion surplus was fully used, countries with a Kyoto reduction target would basically not need to do anything to protect the climate until 2026*

In Doha, countries also decided to restrict the number of emission permits a country can receive for the second Kyoto commitment period, in order to avoid the build-up of new surplus. This change was heavily contested by Russia, Ukraine, Belarus, Kazakhstan and others because it essentially makes it impossible for countries to accumulate new 'hot air' by choosing a weak target. The compromise decision adopted in Doha doesn't limit the carry-over of AAUs but puts limits to their use in the second commitment period. It also makes it impossible for countries not participating in the second commitment period to sell their surplus to countries with a reduction target in the same period. To underline their climate commitments, several countries made political declarations that they will not buy such AAU surplus in the second commitment period.

Although we did not get full cancellation of 'hot air', the Doha outcome on the surplus can be seen as a success. Parties decided that some, but far from all, 'hot air' will be used until 2020. Also, countries have to take a

commitment for the second commitment period that de facto does not allow them to increase their current emissions. This sets an important precedent for future decisions.



## Doha Decisions on 'hot air' from the first commitment period

An agreement at COP18 depended on the support from the European Union. However, the EU had tried to come to an internal agreement on the issue over the last three years but was unable to do so because of staunch opposition from Poland to put any kind of limitation on the surplus.

Together with Russia and Ukraine, Poland threatened to stop any meaningful decision in Doha. This was dangerous because an unresolved surplus issue would have threatened the viability of the second commitment period.

It was only on day 10 of the 2-week negotiations that the EU finally came to an internal solution. It was a compromise between those EU countries that had fought hard for very strict limitations on the surplus (e.g. Germany, UK, DK) and Poland and some other Eastern European countries on the other hand.

The [final Doha decision](#) that was passed in Doha is very similar to the EU's internal decision and includes the following:

### Full carry-over of AAUs

Existing Kyoto Protocol rules on carry-over of AAUs were not changed. Countries with surplus AAUs from the first period of the Kyoto Protocol can carry them over fully to the second commitment period.

### Limitation on use of carry over

Although countries can carry over their surplus in full, there are some limits on how they can use it:

- Countries that take a reduction target under the second commitment period of the Kyoto Protocol can use their own AAU surplus to meet their own targets.
- Countries that have a reduction target under the second commitment period can buy up to 2% of the number of AAUs they received under the first commitment period from other countries.

### An unclear Status for surplus units of countries not participating in the second commitment period

Some countries have surplus from the first commitment period but are not participating in the second period, most notably Russia with close to 6 billion surplus AAUs. The Doha decision does not allow those countries to sell their surplus to a country with a target in the second commitment period. But the decision is unclear on what exactly happens to that surplus during and after the second commitment period (see below). The views differ on this and depend on the technical and legal interpretation of the texts (see our more in-depth [policy brief](#) on the AAU Doha

decision). We would argue that AAUs were created as a policy tool to reduce emissions under the Kyoto Protocol and that they have no intrinsic value outside the Kyoto system.

## **An unclear Status on the Kyoto surplus after 2020**

The final Doha agreement does not mention what will happen to any surplus at the end of the second Kyoto commitment period. In other words, there is no explicit cancellation of surplus in 2020. It therefore remains unclear what will happen to any of the remaining surplus of emission permits at the end of the second commitment period. Again, the views on this issue also depend on the legal interpretation on what constitutes an AAU. Surplus holding countries will likely try to bring their permits into a new post-2020 agreement.

## **Political statements on surplus use**

EU, Japan, Australia, Norway, Switzerland, Lichtenstein, and Monaco made political statements not to use AAU surplus from other countries to meet their commitments.

The EU declaration is weaker than the rest of those made which explicitly stated that they will not purchase surplus AAUs for compliance with their second commitment period targets. For details on this see our new *policy brief*.

## **Doha Decisions on ‘hot air’ from the second commitment period**

In Doha, countries also decided to restrict the number of emission permits a country can receive for the second Kyoto commitment period, in order to avoid the build-up of new surplus. The new amendment of the Kyoto Protocol (see [Doha amendment paragraph 3.7ter \(p.10\)](#)) ensures that commitments made by countries for the second commitment period are stringent enough that they are unlikely to create new ‘hot air’. A country that takes a reduction commitment can only use new AAUs equivalent to the average of its emissions between 2008 and 2010 multiplied by 8 (the length of the commitment period). The rest will be cancelled and can thus neither be used for domestic compliance nor for trading.

The amendment makes it impossible for countries to take a new commitment that is so weak that it creates new ‘hot air’. Ukraine, Belarus and Kazakhstan have all since threatened to withdraw from the second commitment period because of this paragraph. Russia had always said that it would not join.

## **Next steps**

The solutions on ‘hot air’ taken in Doha are complex and it is still unclear how exactly the Doha decisions on the surplus from the first commitment period and the amendment on the limit of AAUs in the second commitment period will work together. Legal clarifications are needed and it is likely that countries will have to take further implementing decisions to clarify the operationalization of the rules.

# Joint Implementation: CDM's little brother grew up to be big and nasty

*Joint Implementation (JI) offsets account for one third of all Kyoto carbon offsets that have been issued to date. Despite the fact that JI has been marred by a lack of transparency and represents a glut of credits with very questionable environmental integrity, they continue to be used for compliance in Europe and elsewhere. It remains to be seen if the ongoing UN reform of JI will bring the changes needed to turn JI into a mechanism that actually will deliver real and additional emission reductions.*

JI is the carbon offset mechanism for projects in countries with a reduction target under the Kyoto protocol. It has long been the little brother in the shadow of the Clean Development Mechanism (CDM). In the first years of the Kyoto Protocol only a few projects generated credits and JI was considered a minor player in the carbon market, but this has changed dramatically over the last year. JI is now responsible for over one third of all offset credits issued under the Kyoto Protocol. In 2012, around 658 million JI credits (Emission Reduction Units – ERUs) were issued to 582 JI projects in comparison with 1.2 billion credits of Certified Emission Reductions (CERs) being issued to 6392 CDM projects, as Figure 1 shows. This means that 80% of all ERUs ever issued were done so last year!

JI has two different tracks: Track 2 has a governance structure somewhat similar to the CDM where projects are overseen by an international body – the JI Supervisory Committee. Track 1, on the other hand, allows countries that host JI projects to set their own rules, approve projects, verify emission reductions and issue credits. Of all the credits from JI, 97% have been issued through Track 1. As such, JI has been marred by a lack of transparency and a glut of credits with very questionable environmental integrity.

Unlike the CDM, JI offsets are issued by a host country through the conversion of its emission allowances (Assigned Amount Units – AAUs) into an equivalent number of ERUs. This ensures that there is no double counting of the emission reductions and helps to maintain environmental integrity in countries with stringent targets. Such countries are careful not to convert AAUs to ERUs from JI projects that are not additional. However, countries with a large surplus of AAUs, so called “hot air”, can use the JI for “hot-air laundering”, i.e. exporting surplus AAUs (which are hardly tradable now) in the form of ERUs. It is therefore not surprising that the countries that have issued most JI credits, Ukraine and Russia, are also the ones with the biggest AAU surplus as Figure 2 shows.

## Credits issued, million

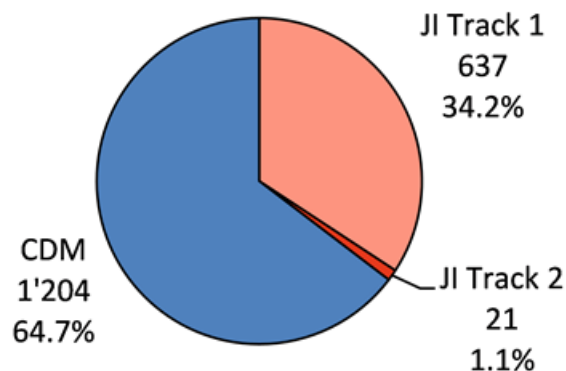


Figure 1. Numbers of emission reduction credits in CDM, JI Track 1 and JI Track 2 as of February 2013 (based on UNFCCC data).

## Registered projects

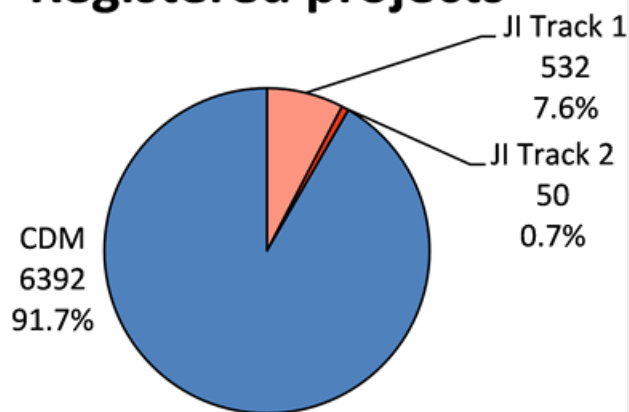


Figure 2. ERUs issuance by host Party as of February 2013 (based on UNFCCC data).



## At current JI offset prices, high quality JI projects stop operating

Despite the integrity issues the JI faces overall, some JI projects are truly additional and have generated real emissions reductions. Unfortunately, many of these may stop operating because they are no longer economically feasible.

The severe oversupply of CDM and JI offsets has led to a market crash with current JI offset prices now below 0.2 EUR. Such low prices make it impossible for the truly additional projects to keep operating, let alone for initiating new JI projects. Even those project types which are considered the most profitable, such as those with N<sub>2</sub>O emission reductions, now struggle to justify verification costs to get ERUs for emission reductions already achieved.

## Weak restrictions on JI credits in the EU ETS

The shortcomings of JI are not new to European decision-makers. In January of this year, the EU Climate Change Committee, a decision-making body comprised of officials from EU Member States and the European Commission, approved the proposal to update the rules of the European Emission Trading Scheme (EU ETS) Registry Regulation. The updated regulation includes restrictions on JI credits used for compliance in the EU ETS. The update will prohibit the use of JI offsets based on emissions reductions that occurred after 2012 if they come from projects in countries that have not joined the second Kyoto commitment period. But ERUs issued for emissions reductions that occurred before 2013 can still be kept and used in the EU ETS if they:

1. are issued under Track 2, or
2. are issued under Track 1 and include a statement from a JI Track 2 auditor that confirms the emission reductions took place before 2013.

The draft proposal initially caused panic in the market because market participants feared severe restrictions on JI credits and tried to sell ERUs as quickly as possible. This caused a significant drop in ERU prices. However, the impact of the updated regulation in the current version will be quite limited. Considering that some JI auditors have shown little qualms in the past to approve JI projects that are clearly not additional, the updated regulation's requirement to confirm that emission reductions took place before 2013 is unlikely to restrict the supply of JI offsets into the EU ETS. This is especially worrying given the large number of JI Track 1 projects that were hastily registered in 2012 and are likely to claim emissions reductions that allegedly took place before 2013.

The new Registry Regulation will now be submitted for deliberation by the European Parliament and the Council. If no objections are made to the new rules within the next three months, the Commission will adopt and publish the amendment and the Regulation will enter into force. In our view the new Registry rules, if adopted as currently described, will have little effect on limiting the oversupply of low-quality credits.

## Doha decisions on Joint Implementation

At COP18 in Doha, Parties agreed to extend the Kyoto Protocol and by doing so they also extended the life of Joint Implementation for the period of 2013-2020. The need for the reform of JI was also discussed, yet most decisions regarding JI were postponed. The Parties were able to agree only on a set of general principles of the future JI framework including:

- Merging the two JI Track into one single Track;
- Common overarching guiding principles, including "clear, transparent and objective requirements to ensure that projects are additional to what would otherwise occur";
- Establishing an appeals process.

The reform of JI will be discussed again under the Subsidiary Body for Implementation (SBI) at the next meeting in Bonn in June 2013.

One of the amendments in the Kyoto Protocol (see paragraph 3.7ter), is likely to have an indirect positive effect on the JI's environmental integrity (see article "[Doha on AAUs: The Future of the Phantom Menace](#)"). As explained, a country with weak targets and lots of "hot air" is often motivated to maximise the issuance of JI credits and set very weak rules for the projects. However, since all countries will have to have a somewhat stringent target under this new paragraph (at least one that will not result in more "hot air") now they will not have spare AAUs they can just "give away" for JI credits.

This will not be the case though if Parties decide to allow for the use of "hot air" from the first commitment period to generate JI credits. Under current UN rules no ERUs can be issued for the reductions achieved in the second commitment period until countries receive their new AAUs for that period. This is also unlikely to happen before 2015. However, if the rules are changed and host countries are allowed to use their old surplus AAUs for conversion into ERUs they will have no incentive to limit issuance of ERUs to only those projects that are truly additional. This issue will likely be a controversial one in the months ahead too. Parties will get together again in June 2013 to further discuss the future of JI. Even still, it is not clear if they will come to a decision on this issue any time soon. For more details, see the Climate Action Network's [submission](#) on JI reform.

*- Carbon Market Watch would like to thank Vladyslav Zhezherin for his contributions to this article*

# Resuscitating the Clean Development Mechanism

During the 7<sup>th</sup> Conference of the Parties (COP-7) held in Marrakesh in 2001, Parties to the Kyoto Protocol decided to review the modalities and procedures of the Clean Development Mechanism (CDM) and agree upon a revised set of rules at COP-19.



Although the political decisions taken at COP-18 in Doha ignored the severe quality concerns over the CDM and further undermined its environmental integrity, the CDM review at COP-19 could be a chance to address some inherent flaws of the CDM. If, however, its quality issues remain unaddressed, not only will the current over-supply of carbon offsets representing more than 4 gigatonnes (Gt) of CO<sub>2</sub> continue to rise, but prices of these offsets will also dive below 1 EURO. It is political will that is making its mark right now. Countries don't only need to set higher emission reduction targets; they also need to tackle the over-supply of offsets by addressing the quality problems of the CDM. Below is a summary of key issues we consider essential to be addressed as part of the review. For more details about these points, see [here](#).

*The CDM review at COP-19 could be a chance to address some inherent flaws of the CDM*

## Key issues to be addressed in the CDM review

**Additionality:** The demonstration of additionality – proof that projects are only viable because they receive CDM support – has long been criticised as ineffective. Research, recently released under the CDM Policy Dialogue, confirms that many of the large-scale power supply and methane projects are unlikely to be additional. If such projects remain eligible in the CDM, they could increase cumulative global greenhouse gas (GHG) emissions by up to 3.6Gt of carbon dioxide equivalent (CO<sub>2</sub>e) by 2020. Producing such non-additional credits also undermine the economic effectiveness of the CDM by artificially increasing the supply of credits that do not represent actual emission reductions. This is especially a problem since the CDM is already projected to be significantly oversupplied until 2020. A transition away from large-scale power supply CDM projects and other project types with low probability of additionality would address the over-supply of CDM credits, enable projects that truly depend on the CDM, and improve the overall environmental integrity and mitigation impact of the CDM.

**Offsetting:** The CDM is a zero sum game: it cannot deliver the large long-term emission cuts required to stay below 2 degrees of global warming. Especially in a future climate treaty, where both developed and developing countries are expected to have climate targets, the concept of pure offsetting is no longer appropriate. Instead the CDM must move beyond offsetting and be adapted to a scenario where multiple mechanisms exist. In order to preserve environmental integrity of offset credits, double counting of emission reductions must be avoided. The CDM must also make space for financing options with strict Measuring, Reporting and Verification (MRV) rules to help developing countries to reap low cost mitigation options for Nationally Appropriate Mitigation Actions (NAMAs) to develop on a low emissions pathway. Higher cost mitigation options should be addressed with other climate mitigation instruments, such as domestic policy instruments, for example using domestic emissions trading schemes.

**Length of crediting periods:** The current crediting periods are, in many cases, not appropriate because the lifetime of many technologies being used are shorter than the crediting periods currently available (10 years or three times

7 years). Another reason is that in many cases the CDM only advances an investment which would be carried out at a later stage anyhow. Such CDM projects should only receive credits for the number of years the projects' implementation has been advanced.

**Human rights:** In 2011, the CDM Executive Board registered two projects despite evidence of human rights abuses in both cases. The Board argued that it has no mandate to address the issue of human rights and that the responsibility for ensuring sustainable development lies with the host country. However, numerous international human rights instruments are indeed relevant to the CDM Executive Board. For example, the Decision 1/CP.16 stipulates that "*Parties should in all climate change related actions fully respect human rights*". The review should clarify that international law, including the UN Charter, fundamentally requires the CDM Executive Board to set up relevant human rights standards and impose them on investors to ensure that CDM projects uphold human rights.

**Sustainable development:** The CDM has two main objectives: achieving cost-effective emission reductions and achieving sustainable development in the host countries. Experience has shown that the lack of monitoring, reporting, and verification of claimed sustainability benefits has led to the registration of CDM projects that have no contribution to sustainable development and sometimes even negative impacts. The CDM review should address these concerns by inter alia including provisions for monitoring, reporting, and verification of the environmental, social, and economic impacts of CDM activities and procedures for a grievance procedure.

**Strengthened civil society participation in the CDM process:** Although stakeholder consultation is a key requirement in the CDM registration process, project participants lack clear criteria or guidance on how to conduct and validate stakeholder consultations. In many cases, civil society, people and communities that are directly affected by CDM projects are not adequately informed about them and their potential on-the-ground impacts beforehand. In addition to shortcomings in these notices and comment processes, there is no means for civil society to raise concerns once a project is registered even if adverse impacts occur during project implementation. As more than 6.000 CDM projects are currently registered and will be operational for many years to come, the current procedure of stakeholder involvement in the CDM needs to be reassessed and improved, for example by introducing a CDM Ombudsman and a grievance mechanism.

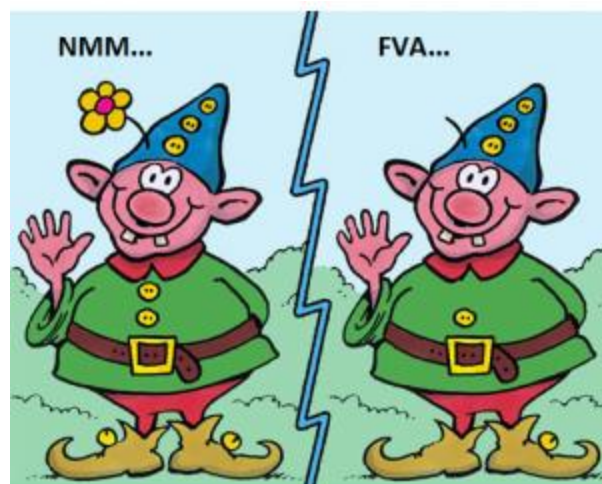
**Liability:** Auditors are currently chosen and paid by a project's developer. This can put pressure on auditors to approve projects and work quickly in order to preserve their business relationships with the developers. This compromises the auditors' independence and neutrality. The review must address this conflict of interest, inter alia by developing rules and procedures under which auditors are assigned and paid by a UNFCCC body and where CDM project developers pay validation and verification fees to that body. In order to ensure that excess credits that are issued due to deficiencies such as fraud and corruption are compensated, the review should also establish rules for dealing with significant deficiencies in validation, verification and certification reports.

**Governance:** The way the CDM Executive Board is operating is often questionable. For example, other than maintaining regional balance there are no selection criteria for the nomination of members. Moreover, the nomination and election of CDM Executive members is not transparent and there is no explicit code of conduct that specifies what constitutes a conflict of interest. Since the composition of the Board directly impacts how CDM rules are developed and implemented, the review must address these issues inter alia by requiring a robust code of conduct, declare meetings of the CDM Executive Board open to the public, and by the set up a transparent nomination and selection process.

# The Folly of New Market Mechanisms

*Despite severely over-supplied carbon markets and missing mitigation commitments by countries around the world to set the world on a low-emission pathway, countries are developing a work programme to implement New Market Mechanisms and a so called Framework for Various Approaches. Needless to say, focusing on the creation of additional carbon credit supply without the political will to increase climate targets doesn't make sense.*

At COP-17 in December 2011, Parties decided that a New Market Mechanism (NMM) should be established under the UNFCCC to complement the Clean Development Mechanism (CDM) and Joint Implementation (JI). Parties also decided a Framework for Various Approaches (FVA) should be created to set some type of common rules for new regional carbon markets. The more recent COP-18 Doha meetings didn't bring much clarity to what such a framework would actually entail but they did conclude clarity was lacking nonetheless. With that, parties in Doha decided to establish a work programme inter alia to address the purpose of the FVA whereupon the decision on how to implement it would be made at COP-19. More details were also reviewed on how to apply NMMs, establishing what rules to follow for delivering real, permanent, additional, and verified mitigation outcomes, avoiding double counting of mitigation effort and achieving a net decrease and/or avoidance of greenhouse gas emissions (GHG). These details will now be further fleshed out and agreed upon at COP-19. For a detailed analysis of the COP-18 outcome see [here](#).



*Common rules need to be established to ensure environmental integrity. It is, for example, vital that offsets from such systems are not double counted.*

At first sight it is difficult to distinguish the difference between the NMM and the FVA. However, the purpose for the FVA is widely understood as the “glue” between different market mechanisms, like NMM, that should make credits fungible and therefore tradable. This is important because new regional carbon market schemes are being developed in several places, including Japan, California and China. If emission credits from such different systems are to be used internationally, common rules need to be established to ensure environmental integrity. It is, for example, vital that offsets from such systems are not double counted. Quality requirements must be stringent because otherwise the cheapest, least stringent offsets will have a market advantage over higher quality offsets.

The framework also includes non-market based approaches. However, it is again not yet clear what this would entail. Carbon Market Watch is particularly confused about the interpretation of some countries saying they are considering trading credits from non-market based approaches.

Another important question relates to the governance system. Some countries, such as Japan, the US, New Zealand and others, argue an FVA needs very “flexible” rules, allowing countries to make their own decisions on what sectors to include, how to set baselines and additionality rules and to allow each host country to issue credits. JI track 1 shows us how such a system would probably look like and what impact it would have ([see article on JI](#)). Such a lenient approach would likely lead to the issuance of a large number of credits with very limited environmental integrity.

There are other countries that are calling for international rules and oversight of the FVA to ensure quality. Such a top-down approach is not very different from the NMM suggested by the European Union and others. Those countries that advocate the NMM are calling for a CDM-like governance structure and tight rules to ensure it will not serve to increase the already huge supply of carbon credits on the market with very limited climate value.

So do we really need both an FVA and an NMM? What use can these have in a world where countries refuse to increase their emission reduction pledges and markets are already severely oversupplied with credits from the CDM and JI? Current offset prices are below 0.20 EURO and are likely to remain at such low levels until 2020. Which countries would be willing to host the NMM under such new stringent rules if these dire market conditions remain unchanged anyhow? And which country would want to buy credits from a new system if cheap Kyoto units are already available?

Carbon Market Watch remains puzzled why the EU would push for an NMM when its own EU-ETS is severely oversupplied. The argument that such a NMM would lead emerging economies to take binding targets seems to be a vain hope. The countries that are developing regional and bilateral carbon markets seem mostly interested in doing so on their own terms and have little interest to comply with stringent UN rules. The likelihood that countries will agree on stringent rules for an FVA is therefore low.

# “Stopping-the-clock” on emissions from air travel – what’s the buzz?

This year is a crucial one for countries to finally address emissions from international aviation, which is responsible for 4.9% of man-made global warming. The Kyoto Protocol requires Parties to find solutions to mitigate emissions from aviation by working through the International Civil Aviation Organization (ICAO). Since Kyoto however, ICAO has proved to be incapable of making any substantial progress. As a response, the European Union decided to include emissions from all flights to, from and within Europe in their Emissions Trading Scheme (EU ETS) as of 2012. The EU’s unilateral decision has been very controversial, triggering major opposition from the US, Russia, India, China and others who in turn threatened the EU with trade restrictions. With the aim to lift political obstacles for ICAO to agree on a global deal the European Commission made a proposal to defer the ETS compliance of international flights to and from Europe by one year. This proposal has recently been supported by the European Parliament’s Environment Committee and will be adopted by the European Parliament in April 2013. Pressure is now on ICAO to advance progress for a global deal which should be decided by September 2013.

## **Homeless industrial gas offset credits must stay out of EU ETS!**

The 2012 aviation emission’s cap in the EU ETS was originally set at 212 million tonnes (Mt), or 97% of the average aviation emissions in the period from 2004-2006 (219Mt). Airlines are allowed to offset up to 15% of the total number of allowances they used for compliance, equaling about 32 million offsets.

The derogation gives airlines the option not to comply with obligations for international flights, or in other words, invites them not to reduce their emissions. If they chose not to participate, they are required to return allowances. The European Commission estimates that over two thirds of the allowances allocated for free in 2012 could be returned and cancelled. This would reduce the number of offsets that airlines will have available to about 10 million.

However, prior to the vote in the Parliament, some proposals were made against returning the unused allowances. Not only would this have allowed some airlines to offset nearly 100% of their emissions, it would have also added about 20 million extra credits into an already oversupplied ETS. Worst of all, these 20 million credits would have likely come from industrial gas offsets projects in India and China. This is highly problematic because industrial gas offset credits are artificially inflated reductions and therefore do not represent real emissions reductions. As a response, the EU has implemented a ban of these which will come into force in May 2013 and essentially made these credits “homeless”. Luckily the Environment Committee rejected this proposal! Plenary vote will be on 15 April.

## **Offsetting in a global deal for aviation emissions**

The International Civil Aviation Organization’s group of experts, which provides technical advice to ICAO’s Council, made recommendations last year for a global deal that would include either a global offsetting systems or a cap-and-trade scheme. All options currently on the table involve the use of offset credits to compensate for emission reductions. While an offsetting system would require airlines to pay into a central fund that would purchase carbon offsets, a cap-and-trade scheme would allocate a number of emissions allowances equivalent to the tonnes of CO<sub>2</sub> an airline operator would be allowed to emit. To meet their obligations under a cap-and-trade scheme, an operator could either reduce emissions, purchase emissions allowances from other operators or buy carbon offsets from an offsetting mechanism that is approved under the cap-and-trade scheme.

It is still unclear what types of offset credits would be approved for compliance under either system. A large variety of offset credits exist. However, only certain types of offsets are allowed on the international compliance market and these must comply with a set of minimum standards. They include offset credits from the Clean Development Mechanism (CDM) and Joint Implementation (JI) set up under the Kyoto Protocol (KP). A New Market Mechanism (NMM) is currently being developed under the UNFCCC and could potentially generate additional offset credits. Offset credits are also produced outside the UNFCCC. These include voluntary offset programmes (e.g. Verified Carbon Standard), national offset programmes (e.g. Australia's Carbon Farming Initiative), bilateral offset mechanisms (e.g. Japan's Bilateral Offset Credit Mechanism) and regional offset programmes (e.g. Climate Action Reserve offsets allowed under California's cap and trade scheme). Emission permits could also be acquired in the form of allowances from cap-and-trade schemes, such as European Allowances (EUAs) from the European Emissions Trading Scheme (EU ETS).

One offset credit represents one tonne of emissions reductions and can be used by entities with emission reduction obligations to compensate for their emissions. It is therefore essential to ensure that every offset credit is "real, permanent, additional and verified." Every credit that does not comply with these principles causes an increase in global emissions. Also, low quality offsets compromise the economic integrity of an offsetting scheme because they artificially inflate supply.



However, serious concerns lay over credits from the Kyoto flexible mechanisms. An independent study commissioned by the [CDM Policy Dialogue in 2012](#) estimates that two thirds of all CDM credits expected between 2013 and 2020 could come from business-as-usual power supply projects. This is about 3.6 billion tonnes of CO<sub>2</sub>-eq that are potentially non-additional. There are also serious concerns about JI projects for a severe lack of quality control. About 95% of JI credits (ERUs) issued to date are issued by host countries without any international oversight.

Any decision to allow offset credits in a global market-based measure to reduce greenhouse gas emissions from international aviation must be based on stringent requirements that ensure real, permanent, additional and verified emissions reductions. Only offset credits issued under the guidance and authority of the UNFCCC should be eligible for compliance. Additional quality restrictions should be placed on CDM offset credits to address the additionality concerns.

Moreover, the use of offset credits should be supplementary to own in-sector reductions. Any decision to allow cap-and-trade allowances in a mechanism designed by ICAO should ensure that allowances from oversupplied cap-and-trade systems are prohibited. If ICAO decides to establish its own cap-and-trade system it must be based on a stringent cap and avoid over-allocation of allowances. Also, such a cap-and-trade mechanism must not be linked to an oversupplied system, such as the current EU-ETS, as this would severely compromise the environmental and economic effectiveness of an ICAO trading mechanism.



# Short Fix to the Ailing ETS: What next for the world's largest carbon market?

*Although the back-loading plan was meant to be a small intervention to prop up carbon prices, the last seven months of heated debates make this a 'make or break' deal.*

This past week, the Environment Committee in the European Parliament voted in favour of the European Commission's 'back-loading' plan to amend the EU Emissions Trading Scheme (EU ETS) auctioning timetable and temporarily set-aside 900 million emission allowances from the carbon market. The plan, dubbed a 'short term fix', is supposed to prop up depressed prices in the EU ETS that last week hit a new record of 2.81 euro per tonne of CO<sub>2</sub>. While a step in the right direction, it is a shy step towards reforming an ailing EU ETS that is increasingly losing credibility as an effective climate change policy instrument and needs deep structural reform.

The EU ETS is currently facing an existential crisis. With an estimated over-supply of emission allowances at around 2 billion it will hardly bring about the strong carbon price EU needs in order to achieve the long term decarbonising goal of more than 80% by 2050. A massive over-supply of emission allowances has been building rapidly because of the influx of cheap Clean Development Mechanism (CDM) and Joint Implementation (JI) offset credits. To add, dire macro-economic indicators have slashed the demand for these allowances leaving prices currently looming at around 4 euros per allowance. To tackle this massive over-supply, the European Commission has taken a two sided approach: using a short term fix to temporarily set-aside 900 million allowances as the backloading plan and using a set of structural reforms that would ensure stability of the carbon market price in the long term.



Although the back-loading plan was meant to be a small intervention to prop up carbon prices, the last seven months of heated debates make this a 'make or break' deal. The Parliament's Environment Committee argued on many occasions that a market-based mechanism like the EU ETS should not be subject to the intervention of the regulator whenever prices are 'depressed'. But Climate Commissioner Connie Hedegaard publicly insisted on numerous occasions that backloading should be a 'no brainer' as an over-supplied ETS would only drag down carbon prices and this would fail to put industry on a low carbon trajectory. The Parliament retorted in saying it did not want to allow the European Commission 'carte blanche' to interfere in a free market mechanism.

When the Industry, Research and Energy Committee rejected the backloading proposal following a non-binding vote in late January, the markets reacted aggressively and brought down the price of one carbon allowance to an all-time low of 2.81 euros. More recently, the positive vote that the Environment Committee made came at the expense of a compromise amendment that the intervention would be a one off measure during ETS phase III and will last up to 2020. A full plenary vote is expected to be scheduled for 15 April 2013.

What is most important to underline in the backloading debate is that the allowance set-aside is a temporary measure. For long term intervention, the European Commission has published the report “The state of the European carbon market” in November 2012, proposing a set of structural measures to correct the surplus in the EU ETS. Following the report, the Commission launched a public consultation on structural options for the EU Emissions Trading System from all interested stakeholders. Emphasizing the need for several measures, Carbon Market Watch made a submission focusing in particular on one option proposed in the Commission report related to limiting access to international credits. Carbon Market Watch recommends:

1. Eliminating access to international credits post-2020
2. Implementing use restrictions for non-additional international credits pre-2020

For details of the submission, [click here](#).

# What finance for REDD+?

*Forests play a vital role in mitigating climate change and are crucial in the struggle for sustainable development. Not only do they have a fundamental role in the preservation of global ecological systems, they are especially important for supporting the lives and livelihoods of an estimated 1.6 billion forest dependent peoples. The ability of forest ecosystems to fulfill these critical functions is increasingly threatened by the conversion of forests to agricultural land and illegal and unsustainable logging. To address these drivers of deforestation and safeguard forest ecosystems, people and the climate, forest governance must be strengthened both in forest-rich developing countries and at the international level.*

Land use change, principally deforestation, is responsible for 12% to 20% of all global greenhouse gas (GHG) emissions. Reducing Emissions from Deforestation and Degradation (REDD+) is the UN mechanism to provide incentives for developing countries to keep their forests growing and reduce emissions. Under REDD+, payments for forest protection are made by developed countries to developing countries. This payment is tied to performance in deforestation reduction. But an international mechanism for REDD+ is yet to be put in place. Comprehensive financial arrangements for full-scale implementation have not yet been met either. Still, the number of REDD+ pilot-initiatives is rapidly rising.



At COP18 in Doha important decisions on financing REDD+ and associated MRV (Measurement, Reporting and Verification) requirements have been postponed. A final decision on REDD+ was stalled by a lack of consensus on the relationship between finance and emissions verification. Instead, a “work programme” was set-up to discuss how REDD+ could be financed so that a final decision could be taken at COP19 in Warsaw, at the end of this year.

**Submissions on options for financing REDD+ are invited until 25 March 2013 and a first workshop on the topic will be held in Bonn in June 2013.**

A large number of developing countries continue to stress that forest-related activities under the UN Framework Convention on Climate Change (UNFCCC) need to be primarily publicly funded. A majority of developing countries expressed doubts over the appropriateness of market-based approaches and offsetting in particular. Brazil, for example, has repeatedly indicated at UNFCCC negotiations that “appropriate market approaches” for REDD+ should not include international offsets. Still, the idea of harnessing carbon market based mechanisms to support REDD+ has attracted substantial interest and most countries are in favor of them. Although the structure and future of such a potential market remains uncertain, a large share of REDD+ finance has already been spent on “readiness” activities to prepare countries for funding based on demonstrated reductions of deforestation and associated emissions. So, forest carbon markets are again expected to be a hot topic in the upcoming negotiations under the UNFCCC’s Subsidiary Body for Scientific and Technical Advice (SBSTA) in 2013.

## Risks of REDD+ offset credits

While REDD+ is currently not eligible under the Clean Development Mechanism (CDM), afforestation and reforestation (A/R) projects can be registered as CDM projects. Experience so far shows that potential atmospheric benefits of forest carbon projects can easily be outweighed by their negative impacts. Potential REDD offset credits may not represent real emission reductions due to leakage (deforestation is simply displaced from the project site

to another site), the inherent impermanence of forest carbon, inflated baselines, problematic additionality testing and weak rules for MRV. If these credits are then traded in a global compliance market, global emissions would actually rise. However, offsetting is a zero sum game. Even if the credits were additional, allowing REDD projects in an offset mechanism would only shift emission reduction obligations from one country to the other and would not deliver the large long-term emission cuts required to stay below 2 degrees warming. Alternative financing options, such as a fund-based approach, carbon taxes, levies on international aviation or maritime fuels and financial transaction taxes exist and are viable.

### **California's carbon market**

In the meanwhile California's carbon market, the second largest cap-and-trade scheme after the EU, is set to include REDD+ credits from Acre Brazil and Chiapas Mexico. These credits should be used by companies that cannot meet reduction targets. A poorly designed mechanism could fail to reduce carbon emissions, while undermining the rights of forest-dependent people and community-based forest governance. However, despite unresolved issues and wide spread civil society opposition market regulators are close to a deal.

**The REDD Offsets Working Group (ROW) has released its draft recommendations ([here](#)) and opened a period of [public comments](#) until April 30.** If the Air Resources Board accepts the ROW recommendations, REDD offsets may comprise between  $\frac{1}{4}$  and  $\frac{1}{2}$  of the state's offset quota.