

CARBON MARKET WATCH RECOMMENDATIONS FOR UNFCCC SB-38

3-14 JUNE 2013 IN BONN, GERMANY

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INTRODUCTION

At the upcoming Bonn Climate Change Conference from 3-14 June 2013, Parties will negotiate issues related to carbon markets under the Subsidiary Body for Implementation (SBI 38) and the Subsidiary Body for Scientific and Technological Advice (SBSTA 38). Countries will also meet to discuss a future climate agreement under the Ad Hoc Working Group on the Durban Platform for Enhanced Action (ADP 2-2).

Demand for carbon market units is at an all-time low. In 2012 the markets for both the Clean Development Mechanism (CDM) and Joint Implementation (JI) have collapsed and prices, currently at below Euro 0.4, may not recover any time soon. Prices are too low to finance low carbon technologies.

The upcoming UNFCCC intercessional gives Parties another opportunity to raise their mitigation pledges and to address the current oversupply of offset credits from both the CDM and JI. This oversupply is in no small part due to the lack of sufficient quality restriction which has led to hundreds of millions of offsets being issued that have limited or no environmental integrity. This year Parties get a chance to improve the quality of both mechanisms, as they are scheduled to revise both the rules that govern the CDM and JI.

While established carbon markets are faltering, policy makers all around the world are planning to implement new market schemes. China, California, Korea, Chile, Quebec and Japan are just a few of the regions and countries that are planning their own carbon offset or cap-and-trade schemes outside the Kyoto Protocol. The World Bank's Partnership for Market Readiness (PMR) is fostering the development of such new market schemes. Under the UNFCCC, countries are negotiating if and how such new carbon markets should be governed internationally and how traded units should be accounted for so that their units can be counted for compliance of targets both under the Kyoto Protocol and the Convention. In Bonn, countries will also continue to discuss whether and how new carbon markets and their units should be approved both under the Framework for Various Approaches (FVA) and through the New Market Mechanism (NMM).

It is vital that existing carbon markets are reformed and new ones designed in way that ensures the environmental integrity of carbon market units and their accounting. Carbon Market Watch will be following the intercessional in Bonn and has developed recommendations on the following issues:

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CDM M&P REFORM

This year the rules that govern the Clean Development Mechanism (CDM), the so called “modalities and procedures” (M&P) will be revised and agreed upon in Warsaw, Poland at the COP-19 by the end of this year.¹ This upcoming intercessional conference in Bonn will be an important milestone for this decision. Parties and admitted observer organizations have already submitted their views and suggestions to the UNFCCC earlier this year in response to a public consultation (see the [submission by Carbon Market Watch](#), which we summarize below, as well as [submissions by Parties](#) and [submissions by other observer organizations](#))

The CDM is in a precarious situation, as demand for its Certified Emissions Reductions (CERs) is very low and is projected to remain low until 2020, if Parties do not increase their mitigation pledges. Because of the lack in demand and the oversupply, prices have dropped over 90% in the last year and a half and are now at around Euro 0.4. This also impacts the quality of offsets. At such low prices, it is safe to say that it is not possible to implement new projects that are additional.

Parties have made different suggestions on how this supply-demand imbalance could be addressed. Demand could be increased, some suggest, by allowing all countries to use CERs for compliance with their mitigation pledges, by encouraging the use of CERs in the aviation and shipping or by buying up large numbers of offset credits through the Green Climate Fund (GCF). The significant over-supply of carbon credits is in no small part due to lenient rules, in particular rules on additionality. Therefore, Carbon Market Watch believes that such large scale “rescue” purchases of offset credits are counter-productive. This is especially so if the purchases involve buying large numbers of offset credits that are from projects with questionable environmental integrity. Instead of using up scarce climate finance to purchase substandard carbon credits, Carbon Market Watch believes that the supply-demand imbalance needs to be addressed by countries raising their mitigation targets and by the CDM reform dramatically improving the social and environmental integrity of the CDM. The CDM can only have a viable future if it is fundamentally reformed. It remains to be seen if there is the political willingness to do so.

FUNDAMENTALLY REFORM ADDITIONALITY REQUIREMENTS

The current rules for the demonstration of additionality, the proof that projects are only viable because they receive CDM support, have long been criticised as ineffective. A large number of current CDM projects are likely not additional – they would have been implemented even without the incentives from the CDM. Carbon credits from such free-rider projects do not represent real emission reductions and lead to an increase in global greenhouse gas emissions.

Research² recently released under the CDM Policy Dialogue confirms that 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 GHG emissions by up to 3.6 Giga tonnes CO₂e through 2020. 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.

¹ Decision 3/CMP.1, which set the current CDM M&P also stated that the first review of the CDM M&P by the CMP is to be carried out no later than one year after the end of the first commitment period. At COP 18 in 2012, at paragraph 9 of decision 5/CMP.8, the CMP reiterated that it shall carry out the first review of the CDM M&P at its ninth session and requested the Subsidiary Body for Implementation (SBI) to prepare recommendations on possible changes to the CDM M&P.

² Assessing the Impact of the CDM. Report Commissioned By The High-Level Panel On The CDM Policy Dialogue. July 2012. http://www.cdmpolicydialogue.org/research/1030_impact.pdf

→ **Carbon Market Watch recommends:**

- **Strengthening additionality criteria** and require, for example, considering the impact of CER revenues on the economic attractiveness of a proposed CDM project activity and to define appropriate thresholds that determine whether a project is deemed additional.
- **Limiting eligible CDM project types** to the ones that have a high likelihood of being additional and excluding those project types with low likelihood of additionality (e.g. large greenfield infrastructure projects).
- **Excluding project types** where baselines and additionality are intrinsically difficult to determine (e.g. because of signal-to noise ratio issues).

CHANGE E+/E- RULES

The E+/E- regulation was designed by the CDM Executive Board with the aim to avoid perverse incentives for policy makers to introduce policies which increase GHG emissions (E+ policies) or not to adopt policies which lower GHG emissions (E- policies). The E+/E- rules are as follows:

- **E+ policies:** Disregard policies adopted after 1997 which “give comparative advantages to more emissions-intensive technologies or fuels over less emissions-intensive technologies or fuels” (referred to as E+ policies) in setting the baseline.
- **E- policies:** Disregard policies and measures adopted after 2001 which “give comparative advantages to less emissions-intensive technologies over more emissions-intensive technologies” (referred to as E- policies) in setting the baseline.

However, the current approach needs to be reconsidered because the current E- rule is likely to result in baselines that are too lenient which in turn can lead to over-crediting. The current E+ on the other hand is ineffective: Policy makers still have perverse incentives to keep existing E+ policies and measures in place, such as fossil fuel subsidies.

In addition, the situation has changed since the adoption of the Bali Action Plan and the Cancún Agreements, where developing countries have pledged to reduce their emissions. Emission reductions might be counted twice in 2020 if no adjustments are made. With the current rules, CDM projects assist developing countries in achieving their pledges and at the same time the CERs from these projects are used by Annex I countries for their Kyoto compliance.

→ **Carbon Market Watch recommends:**

- **E- policies should be considered when setting the baseline.** This would lead to more conservative baselines while the risk of perverse incentives is likely to be low for most sectors.
- **E+ policies that have considerable impact on GHG emissions** and which have high risks for perverse incentives, such as fossil fuel subsidies, **should not be included in the baseline**, irrespective of when they were adopted.

SHORTEN LENGTH OF CREDITING PERIODS

The current crediting periods (10 years or three times 7 years) are in many cases not appropriate because the lifetimes of many technologies are shorter than these crediting periods. 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.

→ **Carbon Market Watch recommends:** The length of the crediting period should be **10 years or less** and should **not be renewable** to avoid issuance of credits from projects that can no longer be considered additional. The length of the crediting period should be defined individually per project type in the respective methodology.

ENSURE THAT ALL CDM PROJECTS UPHOLD HUMAN RIGHTS

In 2011, the CDM Executive Board registered two projects despite evidence of human rights abuses in both cases. The CDM Executive 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 relevant to the CDM Executive Board. For example, the United Nations Charter, which is applicable to all UN bodies, imposes rights obligations on the CDM Executive Board (for example, Articles 1(3) and 55(c) call for international cooperation on economic and social issues and respect for human rights). More specifically, with respect to climate change, the UNFCCC Conference of the Parties decided that *"Parties should in all climate change related actions fully respect human rights"* (Decision 1/CP.16 paragraph 8).

→ **Carbon Market Watch recommends:** Project activities are suspended if they are found not to meet human rights obligations and standards until the relevant concerns have been fully addressed,

IMPROVE THE CDM'S CONTRIBUTION TO 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 have negative social and environmental impacts. Moreover, certain project types in the CDM, such as coal power plants, do not support the goal of the CDM of contributing to sustainable development because they inflict a heavy toxic burden on local populations and ecosystems.

→ **Carbon Market Watch recommends:**

- Defining a **minimum global standard on sustainability** and **"no harm" requirements** that each CDM project has to meet.
- Establishing **mandatory requirements for monitoring, reporting and verification** of sustainability benefits during the entire project cycle.
- **Excluding project types** that support technologies or practices with high GHG emissions and that are associated with other high environmental and social costs (e.g. projects that support the extraction and use of coal).

STRENGTHENED CIVIL SOCIETY PARTICIPATION IN THE CDM PROCESS

Current CDM stakeholder consultation requirements are insufficient as they are poorly defined, regulated and documented. In many cases, peoples and communities that are directly affected by the CDM are not adequately informed about CDM projects and their potential on-the-ground impacts. In addition, there is no means for civil society to raise concerns once a project is registered even if adverse impacts occur during project implementation.

→ Carbon Market Watch recommends:

- **Strengthening and clarifying** the requirements for stakeholder involvement.
- Establishing a **communication channel for case specific matters** and a grievance mechanism to address the social and environmental impacts of specific CDM projects.

SET-UP A GRIEVANCE MECHANISM

There is currently no means for civil society to raise concerns once a project is registered. Under the SBI, Parties have been considering an appeals procedure for decisions by the CDM Executive Board since 2011. The adoption of a robust appeals procedure in the CDM is a critical opportunity to improve good governance of the CDM. Indeed, the appeals procedure must serve the interests of project developers as well as affected stakeholders, so as not to prioritize corporate profit over the public interest. It is essential that the appeals procedure would be complemented by a grievance mechanism to address the social and environmental impacts of CDM projects to ensure access to justice for all and to build the public's confidence in the integrity of CDM project activities.

→ Carbon Market Watch recommends:

- Ensuring that the appeals **procedure is swiftly implemented** and provides for broad legal standing,
- Establishing a **complementary grievance mechanism** to address the social and environmental impacts of CDM projects during implementation of CDM project activity (e.g. when sustainable development co-benefit criteria are not realised as described in the PDD) and to consider and address concerns about human rights impacts of a CDM project raised by or on behalf of individuals or communities.

IMPROVE THE CONSTITUTION AND CONDUCT OF THE CDM EXECUTIVE BOARD AND SUPPORTING BODIES

The CDM has to be governed in a professional, transparent, accountable and independent manner. Experience has shown that the two primary goals of the CDM (real, additional and verifiable emission reductions and sustainability benefits) are not always sufficiently considered by the CDM Executive Board.

→ Carbon Market Watch recommends:

- Requiring that the CDM Executive Board implement **robust codes of conduct** for all members of the CDM governance structure, including the CDM Executive Board, working groups or teams assisting the Board, and members of the UNFCCC Secretariat.

- **Prohibiting nominations** from representatives with **vested interest** in the CDM in order to prevent potential conflicts of interests.
- Ensuring that **quota rules on composition** of the Board are established that ensure that members from environmental and academic organisations are represented.
- **Establishing cumulative term limits** so that Board members may only serve a maximum of two terms of two or three years each.

The CDM can only have a viable future if it is fundamentally reformed. It remains to be seen if Parties have the political willingness to do so.

JOINT IMPLEMENTATION REFORMS

In Doha Parties decided that the two JI tracks should be merged. However, all further decisions about JI were delegated to be discussed at the upcoming meeting in Bonn in June 2013. Below is a short summary of essential reform requirements needed to avoid millions of substandard JI offset credits from Ukraine and Russia.

The JI has had a rather poor track record. Countries such as Ukraine and Russia have been issuing millions of JI credits with virtually no integrity or climate benefits (see [JI article](#) in our last Newsletter). In Doha³ Parties decided that the two JI tracks should be merged.⁴ They also decided to establish common overarching guiding principles, including “clear, transparent and objective requirements to ensure that projects are additional to what would otherwise occur”.

All further decisions about JI were delegated to the Subsidiary Body for Implementation (SBI) and will be discussed at the upcoming meeting in Bonn in June 2013. Below we summarize the most important issues, for more detailed recommendations, go [here](#).

TREATMENT OF JI PROJECTS DURING THE INTERIM PERIOD

For each JI offset (Emission Reduction Unit – ERU) issued, the host country has to retire one of its AAUs to avoid double counting. Under current rules, countries can only issue ERUs for emission reductions after 2012, once the country has issued their AAUs for the second commitment period. This is likely not going to happen until 2015. To enable the issuance of ERUs during that so called interim period, different recommendations have been made such as, using AAUs from the first Kyoto commitment period or allowing ERU issuance under the condition that the country retire the corresponding number of second commitment period AAUs once they have issued them.

However, using AAUs from the first commitment period is highly problematic, because so many JI host countries have large amounts of AAU surplus, so called “hot-air.” The second option is also problematic given that it is unclear if countries will

³ The decision text can be downloaded [here](#).

⁴ JI is currently divided into two “tracks”. Under Track 2 an international board (Joint Implementation Supervisory Committee – JISC) approves JI projects and issuance of credits. Under Track 1, it is the host Parties that approve projects and the verification of emission reduction and issuance of credits (ERUs).

actually ratify the second Kyoto commitment period. So countries could issue ERUs and then not ratify the second commitment period.

→ **Carbon Market Watch recommends:** Current JI rules should stay in place. Issuance of ERUs for emissions reductions after 2012 should only be possible once new AAUs have been issued.

REQUIRE REVIEW PROCEDURE AT REGISTRATION STAGE

The Joint Implementation Supervisory Committee (JISC) has issued recommendations on the revisions of the JI guidelines ([JISC recommendations](#)). The proposed procedure for validation and registration suggests that project registration is exclusively in the hands of a host Party. A review procedure is only proposed at the stage of ERU issuance (**paragraph 48** of the [JISC recommendations](#)), where it can be triggered by three members of the governing body.

→ **Carbon Market Watch recommends** a review procedure by the governing body be included at the stage of project validation or registration.

STRENGTHEN CRITERIA AND REVIEW PROCEDURES FOR BASELINE SETTING AND ADDITIONALITY

JI has to have clear and conservative baseline setting and additionality rules to ensure the environmental integrity of the JI. The suggested rules and procedures are in many instances weak (see paragraphs 30, 32, 33 of the [JISC recommendations](#)). For example, prior consideration providing evidence that JI was taken into account at the planning stage of a project is currently not required of JI projects. Many JI projects registered in 2012 are claiming emission reductions from 2008 or even before.

→ **Carbon Market Watch recommends** to strengthen baseline and additionality rules and procedures, by, inter alia, including prior consideration requirements and requiring a review approval of baselines and positive lists by the international governing body.

IMPLEMENT PROCEDURES TO RENEW CREDITING PERIOD

Many JI projects that were registered during the first commitment period will want to generate ERUs during the second commitment period. But many existing JI projects are no longer additional, given ongoing changes in industry and policy. Such projects should not be able to renew their crediting period.

→ **Carbon Market Watch recommends** a procedure for the renewal of the crediting period for projects registered in the first commitment period that evaluates the baseline scenario and additionality claims of each project.

The future of JI remains uncertain. Given the very low prices of current JI credits and the hundreds of millions of “hot air” ERUs that have been issued under Track 1, more fundamental questions need to be asked: How can we learn from the JI experience and how does it inform the decisions that are being made under the FVA and the NMM (see below)?

FRAMEWORK FOR VARIOUS APPROACHES AND NEW MARKET-BASED MECHANISM

In Bonn, countries will continue negotiating if and how new carbon markets and their units should be approved both under the Framework for Various Approaches (FVA) and through the New Market Mechanism (NMM). We highlight some of the most pertinent issues that are still to be resolved.

At COP 18 in Doha, Parties did not get very far in agreeing on the details for establishing a new market mechanism (NMM) and a Framework for Various Approaches (FVA). The Doha decision includes establishing a work programme under the Subsidiary Body for Scientific and Technological Advice (SBSTA) for the FVA and the NMM. The FVA work program is supposed to:

- address the purpose of the framework,
- develop the scope of approaches to be included under the framework (e.g. market based and/or non-market based);
- develop a set of criteria and procedures to ensure the environmental integrity;
- develop technical specifications to avoid double counting and
- agree on the institutional arrangements for the framework.

The Doha decision text on the NMM is slightly more detailed than that on the FVA and includes a number of important elements, such as:

- Operation under the guidance and authority of the COP;
- Standards that deliver real, permanent, additional, and verified mitigation outcomes, avoid double counting of effort and achieve a net decrease and/or avoidance of greenhouse gas emissions;
- Requirements for the accurate measurement, reporting and verification of emission reductions, emission removals and/or avoided emissions;
- Criteria for the accurate and consistent recording and tracking of units;
- Complementarity;
- The promotion of sustainable development;

In the following sections we highlight a few of the key issues that need to be addressed in order to ensure the environmental integrity of new markets eligible under the UNFCCC.

ENSURE ROBUST GOVERNANCE STRUCTURE

Both the NMM and the FVA “must meet standards that deliver real, permanent, additional and verified mitigation outcomes, avoid double counting of effort, and achieve a net decrease and/or avoidance of greenhouse gas emissions” These principles can only be achieved under a binding and robust international governance structures for both the FVA and the NMM. Having little or no international oversight and quality control over issuance of units traded internationally and used for compliance is dangerous, as it lies in the interest of the host-country to maximize credit generation. The

experience with Joint Implementation Track 1 clearly illustrates that voluntary guidelines will not suffice to ensure the above mentioned principles are met. Both the NMM and the FVA need to have a strong binding governance structure.

→ Carbon Market Watch recommends

- An appointed UN body functions as a standards-setting organization
- All units/credits are approved by this international body
- Credits are fully accounted through a rigorous, robust and transparent common accounting framework.

AVOID DOUBLE COUNTING

Double counting undermines mitigation goals and economic efficiency and must therefore be avoided. In both the Cancun and the Durban agreements the necessity of avoiding double counting is mentioned but not clearly defined. Double-counting of international offsets could reduce the ambition of current pledges (developed and developing countries) by up to 1.6 billion tons CO₂e in 2020, equivalent to roughly 10 percent of the total abatement required in 2020 to stay on a 2°C pathway.⁵

→ Carbon Market Watch recommends

- The use of a common international transaction tracking mechanism for all offsets counted towards pledge attainment, with assignment of unique serial numbers to each ton transacted or registered.
- Clear and specific rules regarding the complementary relationship between CDM, NMM and other regional trading mechanisms are needed to ensure that there is no double counting.
- A common international transaction tracking mechanism for all credits counted towards pledge attainment, with assignment of unique serial numbers to each ton transacted or registered.
- Rules to ensure that offsets are only counted by the buyer and not by the seller.
- Similarly, financial flows should only be counted once. Double counting of financing financial flows may reduce the total amount of financial support from developed countries to developing countries and thus reduce the emission reductions that could occur otherwise. The financial flow related to the purchase of credits by one country cannot be counted as a financial assistance to the host country.

SECURE NET ATMOSPHERIC BENEFITS

Parties decided that new market approaches must go beyond pure offsetting, as it is currently the case under the CDM and JI. Yet Parties have different opinions on how a “net decrease of emissions” should be defined.

If it is defined on a mechanism level it will not necessarily lead to a net atmospheric benefit but it may just help the host country achieve its emissions reductions target. Narrowly defined, net benefit could mean that not all emissions reductions of an offset project are credited, either because a discount rate is applied or because the baseline is such that only emission

⁵ See SEI Working Paper and SEI Policy Brief, 2011, available at <http://sei-us.org/publications/id/424>

reductions above a certain threshold are credited. Such a definition of “net benefit” does not necessarily lead to net atmospheric benefits. If host countries have committed to emission reduction targets (as most of them have for 2020 under the Convention) then the non-credited emission reductions will simply help the host country to meet its own target. In this case there is no global benefit. A global decrease can only be achieved if the host or the buyer country cancels offsets and does not count them towards their reduction pledge.

→ **Carbon Market Watch recommends**

- Quality and accounting rules for FVA and NMM should clarify and ensure that under both mechanisms, a net atmospheric benefit has to be achieved.

UPHOLD HUMAN RIGHTS

The CDM has recently come under criticism because of human rights abuses connected with several CDM projects. There are no explicit safe-guards under the CDM to avoid that credits that come from projects that violate international conventions such as the human rights declaration. Human rights are mentioned in the chapeau of the Cancun Agreements.⁶

→ **Carbon Market Watch recommends**

- Both the FVA and the NMM must ensure that all internationally traded credits come from activities that uphold human rights.

DELIVER SUSTAINABLE DEVELOPMENT BENEFITS

Experience with the CDM shows that the sustainable development criteria set at the national level are usually too general and vague.

→ **Carbon Market Watch recommends**

- For a meaningful contribution to sustainable development, international standards and guidance are needed to define sustainable development indicators and social and environmental safeguards for national authorities.
- In addition, associated reporting and verification standards to monitor and verify claims to ensure actual realization of the stated sustainability benefits need to be put in place.

⁶ http://unfccc.int/files/meetings/cop_16/application/pdf/cop16_lca.pdf