

The Future of the Clean Development Mechanism

Note on the report “A Call to Action” of the High-Level Panel on CDM Policy Dialogue

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This report draws on research at CEPS as well as debates among the members of the CEPS Carbon Market Forum on the CDM Policy Dialogue.

The CMF provides a neutral space where policy-makers and regulators are able to meet carbon market participants and other stakeholders to discuss carbon market regulation and general policy issues. The contents of this report reflect the general tone and direction of discussions on specific topics within the CMF, but its findings do not necessarily represent a full common position agreed by all the participants in the CMF, nor do they necessarily represent the views of the institutions to which the participants belong.

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The CEPS Carbon Market Forum (CMF) feels that the clean development mechanism (CDM) has reached a very important moment and that the reflection undertaken through the High-Level Panel on CDM Policy Dialogue and its report entitled “A call to action”¹ are important elements in the debate on the future orientation of this mechanism.

The CEPS CMF has been supportive of this initiative and hosted two events for the HLP to interact with the Brussels community. Through this note, CEPS would like to provide its reflections on the report, as well as, by extension, its views on the future of the CDM.

The clean development mechanism (CDM) has been through a long and complex growing process since it was approved as part of the Kyoto Protocol (KP). It was designed within the framework of the UNFCCC and the Kyoto Protocol, and reflected the political and economic realities of that time.

It has proven to be more successful than many observers may have expected. Among its key successes, one should acknowledge that the CDM has:

- Successfully harnessed the entrepreneurial power of markets and the private sector to meet sustainable development goals and environmental targets;
- Demonstrated how culture can be changed around the world by putting a value on GHG reduction actions;
- Mobilised more capital for GHG mitigation actions, especially from the private sector, than many established IFIs;
- Provided lessons learned and established standards that were useful for its own improvement, as well as for the design of new market mechanisms around the world;
- Established a link between different domestic markets;
- Served as a splendid example of a public-private partnership and
- Built capacity to address climate change around the world.

Through improvements over the last ten years, sometimes unnecessarily slow and painful, the CDM has now reached a point where it is beginning to function in a reasonably efficient way, under the guidance of a regulatory body, the CDM Executive Board (EB), which has also matured.

One of the lessons learned must be that a regulator, like the CDM EB, while in some ways unique, does not need to reinvent tried ways, and should use the experience accumulated through regulation around the world.

The political and regulatory premises upon which the CDM was designed and built have changed dramatically. As such its orientation, role and functions must be revisited. The new developments that must be taken into account include:

¹ Download report at <http://www.cdmpolicydialogue.org/report/rpt110912.pdf>

- The CDM was conceived as an offset provider. That approach is not acceptable anymore; we need net reductions.
- The source of demand, which has been the EU and Japan, has decided to severely limit, through regulatory intervention, the demand for certified emissions reductions (CERs).
- The economic situation over the last few years has led to lower emissions and a long position for emission permits for the foreseeable future
- The CDM was built in a framework of Annex 1 and non-Annex 1 countries. That framework is changing in the post-Cancun world. Providing funds for development was acceptable whereas providing funds to support your own competition in difficult economic times is not.
- With deeper cuts in GHG emissions than the science demands, new mechanisms are needed. Some of them will be developed at the UN level, while others will emerge from national initiatives. The CDM will lose its 'monopoly' and will need to compete in the marketplace of ideas based on efficiency and efficacy with other mechanisms.
- The orderly world of the KP is being replaced by a fragmented and complex world of market initiatives. This world will require standards to ensure environmental integrity.
- Significant financial resources will be deployed in the future to meet adaptation and mitigation needs. This will require imaginative ways to leverage private sector finance, which will also need access to processes and platforms to identify environmentally credible GHG reduction opportunities.

The questions that need to be answered are:

- Is there a need for an instrument such as the CDM in the future?
- What 'demand' can it fill?
- In the roles identified under the first question, what can be done to adapt it and also continue to increase its efficacy?

The Report of the High-Level Panel on CDM Policy Dialogue lists 12 areas of recommendations, which can be categorised into the following three groupings:

- Strategic/existential
- Credibility/reputational
- Efficiency/efficacy

As a pre-condition for any discussion about the CDM, it must be well understood that there must be demand for its products and services. It must be said upfront that at this time the CDM suffers from a decreasing demand for its services. The CDM produces CERs and there is a clear oversupply in the market, leading up to 2020. It is unlikely that the expertise that the CDM has created in business and the public sector will survive until demand comes back.

The Report of the High-Level Panel proposes a number of ways to address the supply/demand imbalance. Using the CDM as a supply platform to offer environmentally credible GHG reductions that could be used by a Fund looking to deploy funds for mitigation, such as the Green Climate Fund (GCF),² makes eminent sense and is a credible scenario that must be seriously examined. The specifications for the products (type of CERs) accepted can be developed by the Fund. There can be no expectation of a monopoly for the CDM.

The second recommendation, the creation of a Reserve Bank, while an intellectually interesting proposal, is much more problematic and will face what we see as tremendous challenges. Efforts in that direction will require a substantial amount of resources with limited chance of success.

² For details, see <http://gcfund.net/home.html>.

Issues and Recommendations

Strategic/Existential

The CDM will be one of a number of approaches that will emerge in the new fragmented world, and will co-exist with other alternatives. Parties will have a choice on the use of these mechanisms. Use of any of these instruments will be driven by demand and by the national circumstances. For some, as is the case for JI Track 1 and Track 2, Parties may have to fulfil certain criteria.

The CDM will be available to all Parties to host. Hosting, and accepting CERs for compliance, should be, as always, a choice that Parties can make.

There is no reason why CERs can be available for transfer only to countries that have signed up for KP2. It should be available to all Parties that wish to use them for compliance, whether under KP, UNFCCC Cancun-type commitments, or national or sub-national regimes that require compliance. The vision that Parties will adhere to the KP in order benefit from KP mechanisms, as well as that their CC policy is driven by participation in KP mechanisms, is not one that has been validated in the past.

Restricting the use of CDM to KP2 signatories may have unintended consequences, such as:

- Reducing demand for CERs and making the instrument less viable;
- Encouraging the development of other market mechanisms that may be less environmentally credible and outside the multilateral system;
- Negatively affecting other roles that the CDM could play and
- Reducing mitigation efforts, which would be against the objectives of the UNFCCC.

We do not believe that the CDM and its regulatory bodies are set and prepared to assume the role designated for the emerging New Market Mechanisms (NMMs) and Framework for Various Approaches (FVA), nor it is desirable for them to so at this time. The vision for the emerging new mechanisms is very different, covering broad segments of the economy and with a much more significant role for national governments. The NMM should be allowed to define their own identity and culture, but building upon the technical knowledge and experience of the CDM.

Once the NMMs and the FVA are established, strong consideration should be given to amalgamating all mechanisms under one regulatory body.

Another role advocated by the report is that of standard-setter. Given that many new mechanisms will emerge, some top down (UN defined), some bottom up, among the greatest challenges will be to have fungibility, environmental integrity and market liquidity. Developing, setting and maintaining common standards will be critical. The CDM has developed a substantial number of methodologies and created expertise. While this cannot be always adopted wholesale, it should nevertheless be used as the basis for the work that will need to be undertaken. The CDM is a project-by-project mechanism, while many of the new additions will be much broader in scope, and may require different approaches.

Credibility/Reputation

The CDM's reputation has suffered from criticism on a number of fronts. The most important ones have been related to the additionality of its projects, the impact on sustainability and the lack of attention to co-benefits.

Since the 1992 United Nations Conference on Environment and Development (UNCED) in Rio de Janeiro, defining sustainable development (SD) priorities has been the prerogative of a sovereign country.

Since promoting SD is one of the two objectives of the CDM, there are strong views that CDM has not really promoted SD, and that this should be accomplished through the introduction of an assessment of the SD impact of projects.

Mandating greater transparency is needed and should be welcomed and implemented. On the other hand, defining what should be reported and how it is to be measured can easily cross the line into imposing definitions of SD on host countries. This could set back the sustainability agenda by creating the perception, but also maybe the reality, that SD is becoming a way to impose foreign standards on host countries.

Similarly, host countries should, and we expect that they are already doing so, monitor the implementation of projects in their countries. They should clearly have the option to withdraw the Letter of Approval for any projects that does not meet national standards and national SD objectives. At the same time it must be recognised that the introduction of such a provision will introduce a high degree of uncertainty. We are not questioning the appropriateness of such an option, but must point out that this will represent not a minor change, but a significant departure, from what was one of the CDM's strengths: international regulation of the CDM cycle. Unless safeguards are introduced, this may simply make the CDM, or any future project mechanism, a difficult proposition.

Additionality has always been a hard criticism of the CDM. Through its counterfactual nature, it can never be a totally objective process. As such, uncertainty should be accepted and mitigated through the use of standardised approaches. While this approach will not eliminate criticism, it will provide more transparency and consistency on how additionality is assessed. Considering that we need large quantities of reductions, this approach will ensure that we produce real reductions within known and accepted material boundaries of uncertainty.

Increased Efficiency/Efficacy

"Reform of the CDM" has been a long and arduous process started in Buenos Aires at COP 10 in December 2004. Unfortunately, what is meant by reform can vary substantially. While some include some of the issues referred to in the preceding section, many others understand it as increasing the efficiency and efficacy of the machine. Much progress has been made in this direction, but it is still not applied in a consistent manner. The regulator, the CDM EB, continues to be heavily politicised, with individual members sometimes bringing in national agendas.

The CDM processes have been simplified and clarified by a good degree. However, it still is, once in a while, ignored when it gets in the way of the political agenda. The main remedy lies in the choice of the members of the Board that are at present closely connected to the UNFCCC negotiating process.

Selection of the EB should be guided by very stringent rules that should emphasise regulatory experience and ensure detachment from the agenda of the UNFCCC negotiating process. Since this is a UN body, nominations should still emerge from regional groups, but they should be subject to approval by the CMP (Conference of Parties serving as the meeting of the Parties to the Kyoto Protocol) under clear guidelines defined above. This, combined with terms limits, may contribute to creating a less politicised Board.

Decentralised systems are generally regarded as being a better proposition than heavily centralised ones. They are seen as more efficient and better able to respond to national realities. However, this must be balanced with the need for consistency and risk reduction. Central issuance of CERs from the EB has been one of the successful features of the CDM. By moving that to the national level it will alter the reassurance that CERs will be issued according to instructions to the UNFCCC by those authorised through contractual agreements. Uneven implementation of issuance and destination of issued CERs can ruin the credibility of the instrument. "If it ain't broken don't fix it."

Also as part of the governance, an appeals process and grievance mechanism are long-overdue necessities. Instructions had been given by the CMP in Copenhagen to develop such a mechanism. A bad appeals mechanism can become a weapon to create mass gridlock for the CDM.



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