CEPS SPECIAL REPORT
Thinking ahead for Europe

Expanding Carbon Markets through New Market-based Mechanisms

A synthesis of discussions and submissions to the UNFCCC

Andrei Marcu

This report draws on work by the Carbon Market Forum (CMF) at CEPS. 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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Expanding Carbon Markets through New Market-based Mechanisms

A synthesis of discussions and submissions to the UNFCCC

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1. Introduction

At the Durban meeting of the United Nations Framework Convention on Climate Change (UNFCCC), Parties to the Convention and observer organisations were invited to make submissions on a number of issues relevant to the discussions on various approaches, including opportunities for using markets, to enhance the cost-effectiveness of mitigation actions. This report reviews the submissions by Parties and observer organisations, in response to the request for submissions.[1]

Based on the work of the Carbon Market Forum (CMF) at the CEPS, this report is intended as a synthesis of most of the submissions received so far, also taking into account the common threads and understanding emerging from the Durban negotiations and post-Durban discussions.

The CEPS CMF would like to facilitate progress in the expansion of a global carbon market, and regards the negotiations under the UNFCCC as an important venue for the continued development of new market mechanisms (NMMs) as well as a framework for new approaches.

In this context, this report aims at contributing to the European debate on the development of new market mechanisms and carbon markets, as well as to the UNFCCC negotiating process.

It attempts to identify some of the main issues that will need to be addressed during this year, leading to the 18th Conference of the Parties (COP) in Doha, and discusses the various options proposed. It does not, as a first output of the CMF on this issue and given the state of negotiations under the UNFCCC, propose solutions.

We hope it serves as a useful reference document for negotiators.

2. Background

The Kyoto Protocol provides for three flexibility mechanisms: the Clean Development Mechanism (CDM), joint implementation (JI) and emissions trading.

As they have become operational, together with the EU-based cap-and-trade system (EU Emissions Trading System), they have formed the core of a nascent carbon market. This market has grown from nothing to a market of over €100 billion a year, and is one of the substantive and concrete successes of the Rio Conventions. Putting a value on a tonne of carbon has changed the way society looks at greenhouse gas (GHG) emissions.

Meanwhile, as negotiations on a new agreement started, discussions were accompanied by the recognition that there was a new level of ambition as well as a different architecture for the new agreement.

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[1] See paragraphs 81 and 85 of decision 2/CP.17, Outcome of the work of the Ad Hoc Working Group on Long-term Cooperative Action under the Convention, FCCC/CP/2011/9/Add.1, UNFCCC, 15 March 2012 (http://unfccc.int/resource/docs/2011/cop17/eng/09a01.pdf#page=4).

At the same time, significant experience was gathered through the operation of the CDM and JI, which led to the discovery of shortcomings in their operation and limitations in their basic design. This, together with the rapid emergence of mechanisms outside the framework of the UNFCCC, and the beginning of the process for the development of a new climate regime, led many to conclude that consideration of new market mechanisms was a real necessity.

The Bali Road Map under paragraph 1(b)(v) includes the development of "various approaches, including opportunities for using markets, to enhance the cost-effectiveness of, and to promote, mitigation actions, bearing in mind different circumstances of developed and developing countries".[2]

While negotiations of the Bali Road Map have been complex and slow, negotiations of 1(b)(v)have been particularly difficult. For many sessions, no progress could be achieved, with no material being transmitted from one session of the Ad Hoc Working Group on Long-term Cooperative Action (AWG LCA) to another.

After the failure of the Copenhagen COP in 2009, however, it became increasingly clear that the credibility of the multilateral system was at stake, and that progress had to be achieved in the UNFCCC context. It also became abundantly clear that there were strong positions on the use of markets, but that any overall package could only emerge as a compromise if it included provisions for new market mechanisms.

Movement was achieved at the UNFCCC meeting in Panama in October 2011, where a text was forwarded for discussion at COP 17 in Durban. This text was the result of essentially four different groups of positions.

An understanding of these pre-Durban positions is needed to recognise what has emerged from Durban and from the submissions for the 5 March deadline required by the Durban AWG LCA text, as well as future negotiating stances.

The positions described below could be construed as moving on a continuum, from new market mechanisms that exhibit

- A lower level of flexibility and national discovery, increased complexity in operation, and strong certainty in environmental outcomes,

  to

- a higher level of flexibility, allowing new ideas to emerge at the national level, combined with more complexity in coordination and accounting, as well as the increased need for international supervision in evaluating systems/new market approaches and making the information transparent.

1) *No new market mechanisms.* Some Parties took the position that

- markets do not work in general;
- existing market mechanisms, both CDM and JI, have not performed well, in that the reductions were by and large not additional;
- the need for new market mechanisms was conditional upon a second commitment period of the Kyoto Protocol; and
- the targets were not ambitious enough to warrant a discussion and potential development of new market mechanisms.

This position has resulted for more than two years in a largely sterile discussion about whether we want to discuss new market mechanisms.

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[2] See paragraphs 1(b)(v) of decision 1/CP.13, Bali Action Plan, FCCC/CP/2007/6/Add.1, UNFCCC, 14 March 2008 (http://unfccc.int/resource/docs/2007/cop13/eng/06a01.pdf#page=3).

It must be emphasised that the discussions in the context of negotiations did not allow for any serious or substantive input by Parties to articulate their proposals in any depth.

As such, upon arrival in Durban, positions were more sketched out than developed and explained in detail. This resulted in difficulties at the Durban negotiations with issues of substance, but also with issues concerning the terminology used. As discussed below, this continues to be one of the issues emerging from the 5 March submissions.

2) Development of a new market mechanism. Some Parties promoted the vision of a mechanism that would

- have a crediting and trading component;
- cover broad sectors of the economy;
- be defined globally, but with flexibility to allow for the recognition of local circumstances (the 80/20 rule); and
- ensure strong environmental credibility.

This has become known as the 'sectoral mechanism', but with features that make it clear that it is very different from the initial discussion about transnational sectoral approaches earlier in the negotiating process, which sought to ensure cross-border sectoral commitments.

3) Define a framework. This approach, supported by some Parties, promoted a vision in which

- new mechanisms can be designed and proposed top-down and bottom-up;
- top-down mechanisms would be designed and approved by the COP;
- nationally defined mechanisms would need to be examined and approved by the COP or a COP-mandated regulatory body, according to a set of international standards;
- local flexibility, innovation and local circumstances can be taken into account;
- potential filtering by 'buyers' of units is included; and
- strong regulatory oversight is needed to ensure 'a tonne is a tonne'.

4) High level of flexibility. This approach promoted a vision in which

- Parties could introduce new mechanisms;
- these mechanisms would be recorded and acknowledged;
- Parties, based on their declaration, would have a strong reputational incentive to maintain environmental integrity; and
- there would be no 'oversight', approval process or UNFCCC-level enforcement powers.

3. Durban decisions

In Durban, a number of agreements were reached. For the first time, under a provision included in the Durban text under the AWG LCA, it was agreed that a market mechanism would be created in the UNFCCC context, under paragraph 83, which "defines a new market mechanism operating under the guidance and authority of the COP".[3]

This is the *top-down* element of the new market mechanism, which almost all Parties accept can go ahead and be defined under the auspices of the UN. Units resulting from this new mechanism, which is expected to take a sectoral form, were understood to qualify for compliance under the second commitment period of the Kyoto Protocol and any future UNFCCC obligations. This is reflected in provisions in the decision text of the Ad Hoc Working Group on Further Commitments for Annex I

[3] See paragraph 83 of decision 2/CP.17 of 15 March 2012 (op. cit.).

Parties under the Kyoto Protocol (AWG KP) from Durban.

There is also a *bottom-up* element in the AWG LCA text regarding the creation of new mechanisms. The text notes in the preamble that "Parties may…develop and implement such approaches in accordance with national circumstances".

Paragraph 79 also speaks of "various approaches, including the opportunity for using markets…[which] must meet standards that deliver real, permanent, additional and verified emissions reductions". Paragraph 80 refers to a "work programme to consider a framework for such approaches".

In its provisions for a bottom-up approach, the AWG LCA text from Durban is very imprecise, as some options were unacceptable, a 'red line', for some Parties, and as a compromise needed to be reached, this led to language that had to be ambiguous.

Still, it must be emphasised that this is a fundamental matter for the new market mechanism, as well as the development and evolution of the GHG market post-2012, as discussed below.

In the course of the Durban discussions one issue was whether mechanisms emerging bottom-up from Parties *needed a set of centrally defined 'core elements'* or standards that all new approaches aimed at producing units traded internationally and used for compliance with obligations under the UNFCCC would have to observe.

The second issue was squarely whether newly created mechanisms needed to have *central oversight* to ensure that the core elements/standards referred to in paragraph 79 are adhered to, and what role, if any, the UN would play in such oversight.

This matter is fundamental, as it will affect (at least at the beginning), the fungibility of units and market liquidity. There was clear discomfort among some Parties at the prospect of subjecting their national or bilateral agreements (or both) to external oversight.

At the other end of the spectrum were Parties clearly taking the stance that a strong central body was needed for this role. Yet others felt that a transition period would be required, in which loose or no oversight was required as an intermediary step in an evolutionary process.

It is important to recognise that many Parties, both Annex 1 and non-Annex 1, have proposals for new mechanisms that would need to be accommodated, and visible lack of progress on the definition of the framework would signal the lack of an avenue for the implementation of their own approaches.

At the same time, under the provisions of the Durban AWG KP text, units from new market mechanisms under the Convention will qualify for compliance during the second commitment period of the Kyoto Protocol. There were significant efforts in Durban to tie this provision to solving the issue of carrying over assigned amount units from the first commitment period of the Kyoto Protocol. In this regard, there were restrictive proposals from the ALBA group (Antigua and Barbuda, Bolivia, Cuba, Dominica, Ecuador, Nicaragua, Saint Vincent and the Grenadines and Venezuela) as well as an African proposal, either banning all carry-over or severely limiting the use of carry-over units in future years.

4. Submissions on the new market mechanism and framework

The submissions considered in this report are discussed under the NMM and the framework, as outlined below.

4.1 Issues related to the new market mechanism

The creation of a new market mechanism was clearly a red line for a number of Parties – no NMM, no Durban deal. To start with, we need to summarise what the Cancun and Durban texts give us. An outline of the vision is in paragraph 83 of the AWG LCA Durban text, which

> [d]efines a new market-based mechanism, operating under the guidance and authority of the Conference of the Parties, to enhance the cost-effectiveness of, and to promote, mitigation

> actions, bearing in mind different circumstances of developed and developing countries, which is guided by decision 1/CP.16, paragraph 80, and which, subject to conditions to be elaborated, may assist developed countries to meet part of their mitigation targets or commitments under the Convention.[4]

This decision seems to highlight a number of elements, i.e. a mechanism

- operating under the authority of the COP;
- promoting cost effectiveness;
- and as guided by paragraph 80 of decision 1/CP.16,
  - ensuring the voluntary participation of Parties, supported by the promotion of fair and equitable access for all Parties;
  - complementing other means of support for nationally appropriate mitigation actions (NAMAs) by developing country Parties;
  - stimulating mitigation across broad segments of the economy;
  - safeguarding environmental integrity;
  - ensuring a net decrease or avoidance of global GHG emissions;
  - assisting developed country Parties to meet part of their mitigation targets, while ensuring that the use of such a mechanism or mechanisms is supplemental to domestic mitigation efforts;
  - ensuring good governance and robust market functioning and regulation; and
- able to assist developed countries to meet mitigation targets subject to some conditions.

In the submissions, it **is generally accepted, but by no means a consensus,** that the NMM could have some of the following features:

- The NMM could be sectoral in nature.
- Some submissions refer, as a default, to sectoral crediting, and discuss to a much lesser degree sectoral trading.
- Sectoral crediting could be used to issue credits, *ex post*, after mitigation actions were undertaken, if emissions for the sector covered are under a crediting threshold, which itself is anticipated to be lower than the business-as-usual (BAU) baseline. The number of credits issued will represent the difference between the crediting threshold and actual emissions at the end of the period.
- Sectoral trading could be used to issue allowances to installations in the covered sector. Any excess of allowances residual relative to the actual emissions of the sector are surplus, and can be sold on the market. If there is a shortage at the end of the compliance period, the installation must make up the shortfall by buying permits on the market. While in this case there is an *ex-ante* distribution of allowances, which can be monetised to finance mitigation actions, what is actually true is that there is also an emissions target/ceiling accepted by the sector, which needs to be respected.
- The NMM is to be operated under the authority of the COP or a designated regulatory body, and will be defined and designed through a COP process. In that way, it can be viewed, as a simplification, that it has strong elements of a top-down mechanism. That does not need to imply rigidity, however, or lack of adaptability to local conditions.
- The NMM is to have top-down rules and bottom-up implementation (the 80/20 rule). The NMM will be defined through a set of rules/standards. The rules/standards that ensure environmental

[4] Ibid.

integrity will be defined at the global level. Yet there will be some level of flexibility, allowing for implementation/definition at the national level, to reflect local circumstances. The rationale for this is related to ensuring

- environmental integrity;
- that any variations at the local level in defining the NMM would not result in breaking the fundamental principle that 'a tonne is a tonne'; and
- market fungibility for the units produced for the NMM and market liquidity.

- A process of compliance with the rules/standards is to be established.
- A process to review and revise the rules/standards is also to be set up.
- The NMM is to achieve net emission reductions.

One might conclude, given the points above, that we are in effect dealing not with one mechanism, but at a minimum with two relatively distinct mechanisms –sectoral crediting and sectoral trading. While they share in common sectoral coverage, they are very different in many fundamental ways (e.g. the timing of permit issuance, where the obligation for compliance lies).

In turn, both of them, by allowing standards/rules to be implemented at the local level according to national circumstances, create further branches. These further branches could present characteristics that would make each of them as distinct as sectoral crediting and sectoral trading are from one another.

We could therefore more accurately say that the NMM, by defining the global rules/standards and allowing national implementation, in effect defines a set of mechanisms or possibly a framework/structure/outline (for lack of better words) for market mechanisms.

The opportunity for overlap (and confusion), **as a concept**, with the "Framework for Various Approaches", as defined in the Durban AWG LCA text, emerges. Hence, in our view, this will be one of the issues that should be clarified on the road to Doha, starting with the May UNFCCC negotiating sessions in Bonn.

That case is actually made in a number of submissions, which refer to the need for the NMM to allow for the definition of other mechanisms beyond the anticipated sectoral trading and sectoral crediting.

The COP mandate outlined in the AWG LCA Durban text calls for the development of modalities and procedures for the NMM. In the submissions reviewed so far, and through the work done at CEPS, at this time we can distinguish different views on a number of issues, including the following ones (not an exhaustive list):

- the requirements for Party participation;
- who can participate (Parties, public and private entities, etc.);
- the approaches covered by the NMM;
- sector coverage;
- boundaries;
- methods to determine baselines;
- the determination of crediting thresholds;
- the length of the crediting/trading period;
- the measurement, reporting and verification (MRV) requirements;
- provisions for the issuance and tracking of units;
- the avoidance of double counting for reductions and finance flows, including coordination with existing project-based mechanisms;

- institutional arrangements, including oversight issues;
- the allocation of reductions between developed and developing countries;
- the rules for permanency;
- share of proceeds;
- rules for supplementarity and the setting of numerical targets;
- the recognition of early action;
- the treatment of small island developing states (SIDS), least developed countries (LDCs) and vulnerable African countries;
- the transmission of price signals from the aggregate to the individual level;
- issues of sustainability; and
- technology neutrality.

We outline some of the positions and options presented in the submissions, and also those discussed within the CEPS CMF Task Force on New Market Mechanisms. This is done for some of the issues listed above, but not all. It should be recalled that this is not intended as a summary, but a synthesis, and as such not all views may be represented. Also, some of the issues listed above are to some degree self-explanatory.

Participation

On the issue of participation requirements, points have been made in the submissions on the participation of developed and developing countries.

Among those expressed were these views:

- Any and all Parties can use the NMM under the Convention, **or**
- any and all Parties can participate, but some conditions need to be met to make use of the NMM. This is in some ways not dissimilar to the current use of mechanisms under the Kyoto Protocol. For developing countries, some of the conditions being outlined would include
  - appointing a competent authority;
  - setting up a system for MRV in the sector(s) covered;
  - developing a registry;
  - estimating the baseline, and being able to demonstrate that it is significantly under the BAU baseline, through a technical review;
  - having in place a system to guard against double counting; and
  - being able to define these elements in an *ex-ante* report, and being able to defend the implementation annually, in an *ex-post* report.

The concept of facilitated participation is also raised, for Parties to have access to the NMM, which brings us back to concepts similar to the compliance regime under the Kyoto Protocol.

According to some submissions, to have access to the NMM developed countries should also have to meet some conditions, such as

- having emission reductions targets/commitments that are legally binding at the international level, in the form of a single number and economy-wide; and
- having in place a national system for estimating emissions.

Coverage

Different submissions have made points regarding the range of installations that would be covered under the NMM. This refers primarily to what should constitute a priority for coverage, as well as any conditions that should be met, such as

- the use of IPCC (Intergovernmental Panel on Climate Change) inventory guidelines and justification for any deviation;
- the size of the facilities to be covered in a sector, to make it practical and material;
- the GHG mitigation potential of sectors, sub-sectors or groups of installations;
- the suitability of certain sectors for market instruments, including data availability and responsiveness to price signals (as well as lack of suitability of certain sectors for the NMM); and
- the opportunity to create financial incentives supported by the NMM.

Also, it has been pointed out that it would make sense to start with sectors that would be less complex, and which would be useful to provide proof of the concept.

Boundaries

The views on this issue revolve around whether the whole sector has to be covered or possibly only a sub-set, or a number of installations. Cross-sector interactions should also be considered as well as the risk of leakage.

Baseline determination

This matter is clearly critical and is viewed as something that will require review at the global regulatory level. It should not be a simple extrapolation of historical data, but account for existing policies and measures, while for new installations one suggestion is the average of the top 10%.

In addition, and to the largest extent possible, the same methodology should be used for the same sectors, as general guidance. The methodology for baseline determination should address as main principles, accuracy, completeness, reliability, sensitivity, materiality, conservativeness and context.

Determination of the crediting threshold

This discussion overlaps with that on net emission reductions, in that the crediting threshold should be well below the baseline discussed above.

Factors to be considered in setting the crediting threshold include the capabilities of the sector in that country and the long-term policy perspective. The crediting threshold can be given in absolute or relative terms.

The approaches mentioned are based on historical data and trends (which seem not to draw much support) and a specific technology or modelling approach.

One issue raised is that of creating perverse incentives (e.g. creating an incentive to postpone policies).

Crediting periods

Crediting periods could be shorter at the beginning and then lengthened as we gain experience with the NMM. During this period, the crediting threshold should be fixed but have the capability to be reviewed and modified after each period.

MRV requirements

MRV is seen as a critical international standard for environmental integrity and ensuring that ‘a tonne is a tonne’. MRV provisions should include national arrangements covering

- the responsibility for MRV and data storage;

- provisions for transparency;
- provisions on data source quality, default factor use and conservativeness;
- independent verification; and
- the accreditation of verifiers.

One approach to be considered is the proposal to use procedures that are similar to those used for GHG inventories and national communications. In some cases, use of the IPCC's tiered approach could also be explored.

Issuance and tracking of units

Permits/units should be issued in a national or international registry and the international transaction log (ITL), as an important element of the existing infrastructure that will be critical to avoid double counting. Issuance will only take place once there is compliance with international obligations, as discussed above.

One solution being proposed is the introduction of unit accounting under the Convention and the introduction of a common unit to underpin the entire NMM. While interesting, this matter will be the subject of discussions and negotiations beyond the scope of the NMM.

Avoidance of double counting

Double counting should address the double counting of GHG reductions and finance. Avoidance of double counting can be addressed through the use of the ITL, correct tracking and accounting.

In this context, concerns have been aired with respect to existing CDM projects in sectors covered by the NMM. A number of views have been expressed.

Since investment in CDM projects has taken place, it is felt that those projects should be excluded from the sectoral coverage and allowed to continue under the CDM regime and to issue credits.

Institutional arrangements

Institutional arrangements can be discussed at a number of levels. At the national level there has to be a designated national authority, as there is now under the CDM, with expanded capabilities and responsibilities, responsible for MRV, possibly setting up and managing the registry, submitting annual reports for compliance with conditions for participation in mechanisms, etc.

At the international level there must be a regulator, under the authority of the COP, which could have review teams, as well as a body that considers questions of implementation.

Also, as international institutional arrangements, the bodies mentioned could be set up under the COP directly or they could be part of an 'NMM International Regulatory Body', similar to the existing CDM Executive Board.

The relationship between such a body and the current Executive Board is something that would need to be explored, but consideration should be given to having one regulatory body that deals with new and existing mechanisms.

Recognition of early action

It is critical that the effort starts as early as possible to operationalise and implement the NMM. As such, ways to recognise early action and attribute it value constitute a matter of great importance, and one that was raised in submissions and discussions.

One way to incentivise early action is through pilot projects, which could be given recognition through value for compliance or through other means.

Sustainability

Implementation of the CDM has had, as one of its key provisions, that the definition of sustainable development and approval of projects with respect to this matter would be the prerogative of the host country.

This provision has led to substantial debate triggered by the kinds of projects that some countries had elected to approve and by the fact that in some cases there did not seem to be an elaborate set of sustainable development criteria to which countries could point. Furthermore, an aspect that has recently become a hot topic is that there is no provision to recall an approved project if it is subsequently found not to meet the sustainable development provisions in the initial documents submitted and approved by the designated national authority.

As such, in both the CDM and the NMM, there is a strong push to develop international guidelines on sustainable development. Depending on how they are crafted, this may be a significant and important departure from current provisions ensuring the total prerogative of host countries to decide for themselves what represents sustainable development. The ramifications could be significant and far-reaching.

Transmission of the price signal from the aggregate to the individual level

This matter is closely related to the issue of private sector participation. In their submissions, some Parties and observer organisations expressed concerns regarding the way the private sector, as an investor needed to help fund the target of $100 billion a year, as well as individual installations that would be covered by a sectoral mechanism, will be incentivised, considering that the targets will be at the aggregate level.

There are concerns that the actions of those that will take action and reduce emissions will be negated by others that do not, resulting in an overall failure and no compensation.

This issue can be more easily addressed in sectoral trading, where individual installations would have their own obligations, than it can be in sectoral crediting, where there is only an aggregate number.

In the case of sectoral trading, the overall obligation, should it not be met, would need to be met by some entity, possible the Party or individual installations in proportion to their failure to meet the objectives.

One option that was discussed was government action for collecting credit revenue and deploying it in the form of financing for domestic policies. This may not be an attractive alternative to private sector participants.

For cases of non-compliance, insurance schemes were presented as possible solutions, including interventions by international multilateral organisations, as well as other instruments, such as the Green Climate Fund.

The design of the NMM should account for ‘contractual’-like terms that will alleviate risks. With the CDM, the certified emission reductions are transferred by the UNFCCC to the account specified – and the CDM Modalities of Communication provide a lot of comfort to investors. Something similar needs to be provided in the NMM context.

4.2 Issues related to the framework

If the NMM agreed in Durban was defined under paragraph 80 of 1/CP.16 and paragraph 83 of 2/CP.17 (Durban), then paragraph 80 of 2/CP.17, which refers to the framework, does not provide much detail. This resonates in the many views and options that are included in the submissions, as well as in the discussions of the CEPS CMF Task Force on New Market Mechanisms.

What is the framework?

The framework could be conceived as a *set of rules/standards* that would be used to define, present, document and potentially allow for UNFCCC recognition and approval of various approaches that are defined at the national/regional level.

What is the role of the framework?

This issue has been and continues to be among the critical ones, and will be the subject of difficult negotiations. Its resolution will spell out how carbon markets will evolve over the coming years, with potential implications for unit fungibility and market liquidity.

It must be pointed out that any market-based mechanism or action under the UNFCCC, such as those arising under a framework, can only be relevant the moment units are used for international trading and are intended for use in compliance with UNFCCC obligations, in a jurisdiction other than that where

- the unit of reduction has been produced (crediting), or
- the units have been issued (trading).

There are broadly two views being put forward in the submissions (as was the case in Durban), with a few attempts to provide a bridging solution:

- The framework should be a structure for '**mechanism approval**' under the UNFCCC, and allow systems built outside the UNFCCC to gain UNFCCC recognition, and the units that are produced to be acceptable for UNFCCC compliance obligations. This is a significant move away from the current system, which under the CDM approves reduction units, individually. In this case what is contemplated is the approval of new mechanisms by the regulator, which will then produce units and be operated at the national level, without further operational approval for unit issuance internationally. Those units would automatically become good for UNFCCC compliance. It would focus on criteria for approval that ensure high standards and environmental integrity. This system can be characterised as 'strong compliance, strong centralisation' and would satisfy those who feel that only units resulting from mechanisms that are under UNFCCC oversight can be used for UNFCCC compliance. The main objections to this approach come from those who do not wish to have their systems subjected to international approval and oversight, given their experience with the existing project mechanisms. This approach may be laborious to put into place, as it would require the negotiation of standards used by the regulator for approval, as well as the establishment of a centralised regulator under the UNFCCC or some other designated institution.
- The framework should provide for '**mechanism transparency and reporting**'. In this scenario, the framework would provide general principles for transparency, by specifying a level and format for reporting, and by ensuring that information is available in a coherent and consistent manner in the public domain, such that users and stakeholders can evaluate the mechanisms being used. Supporters of this approach view those governments that use credits as ultimately responsible for ensuring that they meet credible standards. In this scenario, various systems for reporting the kinds of credits and associate standards could include reporting under the International Assessment and Review, and International Consultations and Analysis. Also, in such a scenario, Parties could provide
  - detailed information on the standards and methodologies employed;
  - the categories, types and amounts of international credits transferred to and from another Party;
  - for analysis of the information provided by Parties, and as second step, the opportunity to request additional information, clarifications, etc. under a body such as the Subsidiary Body for Implementation (SBI).

This system would not provide any test for environmental quality or a system of redress, should there be concerns about the integrity of units produced and used for compliance. A number of issues were identified as having the potential to cause problems under such an approach, including scope and technology resulting in choices that would not be acceptable under international supervision. The advantage of this approach is that it can be put in place rapidly, but at the same time it could lead to market fragmentation.

- A 'third way' has been proposed, which would ensure that the role of the framework is initially more of a standard-setter, but would naturally evolve into an oversight instrument.

We conclude that both approaches favour in principle setting strong, environmentally demanding standards. What differentiates them is that one approach sees a greater need for a regulator to intervene, test the systems used and have powers of redress if the systems are found wanting.

What is a standard?

Depending on what the role of the framework is (as discussed above), the standards described in the Durban AWG LCA text can be interpreted in a number of ways:

- In the mechanism approval scenario, they are criteria for approval of the mechanisms that ensure high standards, that 'a tonne is a tonne' and that environmental integrity is preserved. They are seen, in this case, as internationally set and applying to all mechanisms regardless of the jurisdiction from which they emerge. We refer to three broad areas that are provided as examples
  - project activity/eligibility criteria,
  - methodology principles, and
  - monitoring standards.
- In the second case, standards are used as templates and models for information disclosure for the mechanisms developed and used. In this case, there may not be a sole standard, but rather numerous standards, with each jurisdiction being free to develop (potentially) its own standard. The benefit derived from these standards, which could vary from one jurisdiction to another, is that the standards would be made public through the UNFCCC and therefore provide a level of transparency.

NMM standards will be developed at the global and local levels. One could envisage generally that the NMM standards/rules defined globally would be done so in greater detail, and those done locally would represent an implementation level of detail, largely following the direction set globally.

In the case of the framework, the level of detail may be lower at the global level, with more detail emerging locally, as the mechanisms evolve within national and regional jurisdictions.

In the scenario of the framework as a standard setter and transparency provider, standards that would be developed locally for the framework, under general guidance globally, could include

- an overview of the mechanism (process flow, institutions involved, etc.);
- the underlying principles of methodologies and approval processes;
- the roles related to third-party verification; and
- approaches to managing projects and credits.

In the case of the framework as a mechanism approval process, we can expect the framework standard (globally defined) to be more demanding and detailed, and to ensure more consistency among the different market approaches being approved under the framework.

One question that begs to be answered is the relationship between the standards/rules of the NMM, the framework and existing mechanisms (CDM and JI). All these instruments are expected to produce

units that can be used for compliance in the first instance in the second commitment period of the Kyoto Protocol. Later, the same will likely be true for the new climate regime being negotiated.

Given this state of affairs, the units resulting from all these mechanisms must be fungible – ‘a tonne must be a tonne’. It follows that the standards, rules (or whatever they are called) must largely be consistent between what emerges in the NMM and the framework.

The NMM, while itself defined top-down by the COP, should be able to qualify under the standards of the framework. Although not directly mentioned in the Durban text, the fungibility of units and the need for environmental integrity would lead us to such a conclusion. This was also highlighted in at least one submission and may have implications for the regulatory governance of all these mechanisms.

All these issues will need to be clarified at the upcoming SBI session, if progress is to be made on the way to Doha.

Double counting and tracking

As was the case under the NMM, and discussed above, given a potential explosion of new market approaches there is concern about the environmental integrity of the international regime. Again, the solutions will revolve around the role that one sees for the framework.

The ITL, as an existing infrastructure, can play different roles:

- It could transfer units, but also do policy-related checks and verify whether the units come from mechanisms that have been stamped by the UNFCCC.
- It could simply transfer units without performing any checks.
- Or it could simply vanish and be replaced by bilateral links between national registries, which would provide limited transparency and assurance as to what is being transferred and whether there is any double counting.

Can the framework create new market mechanisms?

The Durban text seems to give a positive reply to this question. The framework is meant to allow mechanisms not developed by the UNFCCC process to become UNFCCC-recognised. How that is done may be a matter of dispute, with the potential roles for the framework outlined above in terms of oversight and approval, or simply by providing information and transparency.

It is important, however, to be aware that some hold the view that the NMM will be the place to ‘house’ all market mechanisms, while the framework will play a role in defining non-market approaches.

Governance

It is clear that the UN system is seen as playing a role in the governance of the framework, as do national and regional jurisdictions. Yet the balance between the two levels is largely the result of the role one sees for the framework.

In the mechanism approval mode, the international level defines the standards, provides oversight and tests, has the power of enforcement, provides recognition and licenses to operate and can affect changes in the standards.

National and regional governments develop and propose mechanisms and systems, and operate them once they are approved. Still, they must report and remain in compliance to continue having a license to operate.

In the transparency model, the national level defines standards, operates systems and reports on their characteristics and results. The international level provides guidelines, templates, best practices and coordinates disclosure, but does not have any oversight role.

In both cases the international level is seen as playing a useful part in tracking units, with or without a policy-testing role, before undertaking a transfer.

How to address the concerns of LDCs, SIDS & African countries

There is a general concern that the characteristics of the framework do not account for the needs and priorities of this group of Parties. This concern is expressed in strong terms in a few submissions, but there are no clear proposals on what is needed to address it.

A share of the proceeds – a deduction of 2% of the certified emission reductions generated by CDM projects and used to fund adaptation measures in developing countries – is mentioned, together with ensuring preferred market access for projects from LDCs and so forth, as well as the need to ensure up-front financing.

Building some of these provisions into the framework seems fairly straightforward. Nevertheless, it is unclear if some of the general positions on the share of proceeds, such as collecting **on trading and the transfer of units, not only of issuance** (as is now the case under the Kyoto Protocol offset mechanisms), still constitute a fundamental position for some of the groups that introduced these proposals pre-Durban.

Others would require prescriptive outcomes for the instruments that will emerge bottom-up, and may detract from the entrepreneurial spirit that is hoped to prevail. Much more thought and discussion is needed on this topic.

4.3 Clarification of terminology

It is not uncommon that decisions need to be digested before a common understanding is reached on what has been approved at the COP, in what is invariably, a compromise text.

There are two issues that have emerged from the submissions, however, as well in the course discussions over the last few months, that merit a brief discussion: net emissions reductions and UNFCCC mechanisms.

'Net emissions reductions' is a term mentioned in the Cancun text, as well as in the Durban decision. In mostly refers to ensuring that we go beyond the offsetting model that was applied by the existing mechanisms, the CDM and JI.

One point being made is that offsetting, in principle, may refer to the use of the reduction, and whether some or all of the reduction is being traded and used for compliance or will simply be retired for environmental purposes. In this case, some proposals mention setting aside a fixed percentage of credits or allowances, where the percentage is decided *ex ante* and never used for compliance.

Another way to describe net reductions is through the use of a crediting threshold that is under the BAU baseline (in addition to defining a conservative baseline). Ways of achieving this can vary, but a number of approaches have been proposed, including setting a crediting threshold at a fixed percentage under the baseline or alternatively at a level that is negotiated on a more political and individual basis.

Whatever option is chosen, and in the end this may be a local choice rather than a global rule, it needs to respect the view that offsets are no longer acceptable as an instrument and we need to go beyond them.

One issue that will need to be confronted is that of the existing mechanisms that will continue to produce and co-exist with the NMM and the framework, and are an offset.

Choosing a crediting threshold that is below BAU implies a certain level of comfort that we have the correct BAU, and that we can subtract from it. Given the current experience and the uncertainties around defining and accepting a baseline as valid, one factor that may also need to be considered is the simplicity of maintaining consistency with baseline methodologies under the CDM and JI.

As a second issue, the terms 'UNFCCC mechanisms' and 'mechanism developed outside the UNFCCC framework' are used, but their meaning is not always clear, and that could make a big difference.

A UNFCCC mechanism can refer to a mechanism developed through the UNFCCC process, such as the CDM, or the NMM mechanism as envisaged.

An alternative definition could be any mechanism that was defined through the UNFCCC process or mechanisms that were defined at the national level and subsequently, through the framework, found to meet the standards of the framework and accepted/approved. In this case the units they produce can be used for compliance with UNFCCC obligations.

'Mechanisms developed outside the UNFCCC framework' could include all mechanisms under the transparency/declaratory model. Alternatively, under the mechanism approval model there could be some that are approved through the framework standards and become UNFCCC mechanisms and some that are not.

4.4 Architecture and context

One of the key issues that needs to the understood is the relationship between the NMM and the framework. The concept of the framework was introduced by some Parties, in the 2011 submissions, as well as in Cancun and Durban, envisaged as a set of rules/standards through which any new market mechanism could be tested before it could be accepted by the UNFCCC as meeting standards to deliver UNFCCC compliance-grade reductions.

This vision included top-down mechanisms (developed in the UNFCCC process, e.g. sectoral mechanisms) as well as bottom-up mechanisms (developed at the national level and submitted for approval to the UNFCCC).

Non-market approaches were regarded as being quite different in nature, requiring their own framework.

We now have the Durban text. The Durban outcome has created the possibility of an NMM that could be construed as providing a framework for the development and deployment of a set of mechanisms, mostly sectoral in nature, but not necessarily only sectoral. **At the same time**, the AWG LCA Durban text proposes a framework that will consider, in some way, market mechanisms that emerge bottom-up, from the country level. All these mechanisms must be fungible, however, and as such the frameworks are condemned to be compatible.

One issue that deserves discussion is whether, under a 'project approval' model for the framework, we really need two frameworks – the NMM one and the framework itself.

Another important architectural issue is the relationship between the existing mechanisms, and the NMM and the framework. It is emphasised above that they have to be compatible and fungible.

Another issue that will need to be addressed is the potential conflict with and double counting in relation to existing projects under the CDM, where the same activities are captured under the sectors of the NMM or potentially other market approaches under the framework.

Some submissions simply refer to ensuring complementarity and transparency. Yet this is an important matter considering that all these instruments could potentially have to co-exist in the same country, and maybe within the same sector.

The danger of double counting is real and needs to be addressed for new and existing projects. For existing projects, project participants have already made investments and expect the issuance of certified emission reductions. Changing the rules will further weaken confidence in a market that is already suffering from a lack of confidence in the regulatory and political process underpinning it. As such, issuance should continue, but the reductions should be factored into the BAU baseline.

In sectors covered by the NMM, one approach is not to register new projects, as in this case the baseline would require adjustment.

Also, the new market approaches will certainly intersect with NAMAs, which can be divided into NAMAs that are

- unilateral, where a developing country takes autonomous action to reduce emissions;
- supported, where actions to reduce emissions by a developing country are conditioned upon international support; and
- credit generating, where developing countries earn credits that can be sold internationally.

Given the importance of NAMAs in the new architecture, the concerns that will need to be addressed include the double counting of emission reductions, the double counting of financial support and the possibility that developing countries could sell the low-hanging fruit and end up retaining only the high-cost abatement reductions for their own use.

A special concern expressed in this area is the intersection of market mechanisms with supported and credited NAMAs (where the NMM could be seen as a crediting tool for NAMAs).

Finally, the NMM, CDM/JI and the framework (under any of the models discussed) will need a body to play a regulatory role, more or less intense and active.

The existing infrastructure is currently in place for CDM/JI and one option that should be explored is having all market mechanisms under one regulatory body, which can bring coherence to all of them and build on the experience of the last decade.

4.5 Role of the UNFCCC

The role of the UNFCCC in the NMM and framework has been discussed in various sections of this report. So far, the UNFCCC has played a unique role in the UN system as a market regulator, and the outcome has met mixed reviews.

On one hand it has ensured credibility and impartiality for a system of offsets that will always be subject to criticism. In that way it must recognised that the UNFCCC has provided a very valuable contribution. Also, over the years its efficiency and efficacy have notably increased. On the other hand it is governed by UN rules, which can be seen as rigid and not suitable for a global regulator.

It is clear that for the NMM, the UNFCCC is seen as the oversight body and the regulator. Whether it is through the COP itself, the SBI or functioning in ways similar to the current compliance regime, this is a role that is generally accepted for the NMM.

In the case of the framework, it is seen in different lights, depending on the role of the framework itself. As such, the UNFCCC could be seen as having oversight responsibility as a regulator. Alternatively, it may be called to play a part only in coordination and standard publicising.

4.6 Participation of the private sector

Market mechanisms play a role in efficiently reducing emissions and helping to direct private finance to reach the $100 billion target agreed in Cancun.

In the CDM and JI, the private sector is clear on the risk it takes, the return and how the incentives reach the point of investment. Returns are guaranteed, as the governance ensures that reductions will be issued to the account agreed contractually when the UN system issues them. In this way the UN system plays an important role.

The relationship of the private sector with national governments in the case of the CDM is limited to a Letter of Approval; once it is issued, there is no process for repealing the approval. Under the NMM, and possibly the approaches under the framework, the relationship between business and governments will change substantially.

Given the fact that the NMM requires sectors or sub-sectors to be organised, it will likely require government participation and intervention.

In addition, the fact that reductions are aggregated, but investments may take place at the installation or project level, will also change the nature of the participation and risk profile for business participants.

It is difficult for many private sector players to imagine the incentive in a sectoral scheme, especially of a crediting nature, and governments have not produced convincing arguments so far.

Simply put, some participants may contribute towards the target set while others may not. How to differentiate and reward those that take action is difficult to see, while at the same time ensure that we do not return to a project-based form of measurement.

From that point of view, a sectoral trading approach has appeal, as it is easier to see how the incentive will reach and reward those that have to take action. Still, issues of liquidity and in-country capacity should not be neglected.

5. Issues to look out for

In our view, coming to a resolution on the NMM and the framework in Doha will be, while not a sufficient, a necessary condition for progress and agreement at the next COP, as this is a critical issue for a significant number of Parties.

The discussions since Durban, and the fact that in some cases the two submissions for the 5 March deadline to the UNFCCC are either identical or to some degree reflect ‘cut and paste’ similarities, indicates some lack of clarity in some of the fundamental concepts in the Durban text.

It would be extremely useful if the upcoming workshops on these topics under the UNFCCC, as well as the upcoming sessions in general, could help clarify the vision of the different Parties or groups of Parties on these matters.

While not going into further detail, some of the issues that would benefit from ‘air time’ at the May sessions could include

- the relationship between UNFCCC and non-UNFCCC mechanisms, and notably the question of what a UNFCCC mechanism is;
- the relationship between the standards for the NMM and the standards for various approaches (under the framework);
- views on what constitutes a standard–i.e. a global standard (one) vs. national standards (many);
- the question of what units can be used for UNFCCC compliance, and specifically whether units from mechanisms emerging under the “Framework for Various Approaches” can be used;
- centralisation to ensure environmental integrity and the role of the framework;
- net emission reductions and a common understanding of the concept; and
- the needs of LDCs, SIDS and African countries.

To conclude, what the submissions and discussions post-Durban show is strong support for the appropriate use of markets, under robust regulation and oversight, to ensure that they deliver sustainable development.

List of abbreviations

AWG KP	Ad Hoc Working Group on Further Commitments for Annex I Parties under the Kyoto Protocol
AWG LCA	Ad Hoc Working Group on Long-term Cooperative Action
BAU	Business as usual
CDM	Clean Development Mechanism (under Art. 12 of the Kyoto Protocol)
CMF	Carbon Market Forum (at CEPS)
COP	Conference of the Parties to the United Nations Framework Convention on Climate Change
GHG	Greenhouse gas (the six gases covered by the Kyoto Protocol – CO_2, CH_4, N_2O, HFCs, PFCs and SF_6)
IPCC	Intergovernmental Panel on Climate Change
ITL	International transaction log
JI	Joint implementation (under Art. 6 of the Kyoto Protocol)
LDCs	Least developed countries
MRV	Measurement, reporting and verification
NAMA	Nationally appropriate mitigation action
NMM	New market mechanism
SBI	Subsidiary Body for Implementation
SIDS	Small island developing states
UNFCCC	United Nations Framework Convention on Climate Change