Views on possible improvements to emissions trading and the project-based mechanisms

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The Climate Action Network International (CAN) welcomes the opportunity to provide input on discussions about the future of the flexible mechanisms. CAN is a coalition of more than 450 environmental and development non-governmental organizations worldwide, committed to limiting human-induced climate change to ecologically sustainable levels.

SUMMARY

In CAN's view, discussions about the future of the flexible mechanisms should be firmly grounded in an analysis of their performance so far. In particular, the Clean Development Mechanism (CDM) has failed to meet its dual objectives of supporting cost-effective climate change mitigation and sustainable development in developing countries. In the second commitment period, the CDM requires fundamental restructuring or replacement, and should not continue or be expanded without fundamental reform. Any possible new market mechanisms would need to build on lessons learned.

Most importantly:

(1) Industrialized countries should support climate change mitigation efforts and sustainable development in developing countries as outlined in the Bali Action Plan. From 2013 onwards, industrialized countries must make much deeper cuts in their domestic emissions and also provide financial flows independent of carbon crediting to support decarbonization, adaptation and tropical forest protection in developing countries. **Credited actions in developing countries cannot replace ambitious domestic emission reductions in industrialized countries**.

(2) Current additionality testing is inherently subjective and inaccurate, resulting in the generation of large numbers of spurious credits. Furthermore, it adds unnecessary uncertainties to the CDM process, undermining its effectiveness in supporting projects that *do* need additional support to go forward. Therefore, **any post-2012 instrument crediting emissions reductions in non-Annex I countries must involve a much more effective means for filtering business-as-usual projects.**

Any instrument used to support climate change mitigation in developing countries under the post-2012 regime must avoid these two fundamental problems with the current CDM.

Summary of CAN's views on the potentials and limitations of many of the options proposed in FCCC/KP/AWG/2008/INF.3 to solve these problems.

CAN believes that the only option from FCCC/KP/AWG/2008/INF.3 that has the potential on its own to address both the offsetting and the additionality problems mentioned above is sectoral no-lose targets set well below business-as-usual projections with commitments from Annex I countries to support reductions to the target level. The merits of no-lose sectoral targets depend on the structure of the post-2012 regime. Also, unless carefully designed, this approach risks exacerbating rather than reducing the CDM's problems. Multi-project baselines might also be worth considering for certain types of projects to address the additionality problem, but more analysis is needed to understand for which project types in which countries it is appropriate, and when multi-project baselines becomes impractically complicated. This approach would not address the offsetting problem. Any reformed CDM should not include the crediting of win-win or low-cost options; the inclusion of win-win or low-cost options would allow the cheapest mitigation options in non-Annex 1 countries to be used towards Annex I targets, instead of contributing, with support from Annex I countries, to a "substantial deviation" of emissions from business-as-usual in non-Annex I. Any reformed CDM will also need to avoid creating "perverse incentives" for governments and the private sector to maintain high baselines in order to claim larger numbers of credits. While it may be possible that other reformulations of the CDM are worth considering, all of the other options in FCCC/KP/AWG/2008/INF.3 have serious limitations or risks. We summarize our assessment of the potentials, limitations and risks of each of the options just below, and discuss them in more detail in Attachment 2.

Sectoral crediting: For countries without QELROs, sectoral no-lose targets set well below business-as-usual projections with support from Annex I countries for lowering emissions to the target level merit further consideration. To ensure that this approach solves both the offsetting and additionality problems, the following issues would need to be considered. Given uncertainty in business-as-usual projections, ambitious no-lose targets are needed to avoid non-additional credits, windfall-profits and other market distortions. Ambitious targets are also needed to assure that reductions within the "substantial deviation" needed in developing countries do not also contribute to reduction obligations in industrialized countries. Such targets would need to be accompanied by MRV support to help participating developing countries achieve those targets. Such MRV support is essential to a sectoral crediting mechanism with ambitious targets. Sectoral baselines or sectoral no-lose targets would necessitate having access to detailed and reliable emission inventories: the experience of the first phase of the EU Emissions Trading System underscores the importance of accurate information. At the moment, probably only a few developing countries possess the necessary technical capacity and probably only for a limited number of industrial sectors. Significant capacity building prior to implementation would be required.

Positive/negative list: CAN believes that a small positive list that entirely replaces project-by-project additionality testing could theoretically address the additionality problem, but is likely to be unworkable in practice. Namely, the selection of project types for the list will be controversial and subject to pressure from both private industry and the parties. A positive list that complements project-by-project additionality testing would not solve the existing flaws and is

therefore of little use. CAN does support the use of a negative list to avoid the worst project types, but this alone will not address the fundamental problems in the current CDM.

Discounting: CER discounting could improve the environmental integrity of any of the other options discussed in this position paper, but even in combination would not solve the two main problems of the CDM. If discounting were allowed to justify a weakening of additionality testing, it would exacerbate the CDM's problems. Importantly, it will be difficult to assess the percentage of projects that are non-additional, and discount rates are unlikely to be low enough to compensate for the proportion of non-additional CERs in the current CDM.

NAMAs: Elaboration of the suite of NAMAs that a developing country plans to implement should be supported, but the CDM is most likely not the right mechanism to support all but a limited number of these actions. The definition of this proposal is still unclear, so it is difficult to comment on it until it has been further elaborated. Concerns about the inclusion of NAMAs in the CDM include uncertainties in quantifying the emissions reduced by NAMAs, difficulty assessing the additionality of NAMAs, and from the experience of the first commitment period, there are obvious limitations on the types of NAMAs a crediting mechanism could incentivize. Further elaboration of South Africa and South Korea's proposal on the registry of NAMAs might help clarifying the suitability of CDM as a support mechanism for NAMAs.

Finally, as repeatedly stressed by CAN, the inclusion of **nuclear power** and **CCS** is unacceptable. CAN does not recommend the inclusion of **LULUCF project types beyond the existing afforestation and reforestation category**, and does not support the inclusion of **REDD** in the CDM.

Given the limitations and risks associated with uncapped credit trading mechanisms described herein, it is imperative that attention and resources be placed on other forms of incentives and support for climate change mitigation in developing countries. Other forms of funding are better able to support a wider range of activities, including capacity building, R&D and demand-side energy efficiency, and to target specific types of projects such as those with high sustainable development co-benefits and those in the LDCs.

Two attachments support this summary:
(1) LOOKING BACK TO MOVE FORWARD: PROBLEMS WITH THE CURRENT CDM
(2) REVIEW OF PROPOSED OPTIONS FOR CDM REFORM

Attachment 1:
LOOKING BACK TO MOVE FORWARD:
PROBLEMS WITH THE CURRENT CDM

The following factors substantially limit the incentives to invest in emission reduction projects created by baseline-and-credit mechanisms such as the CDM and JI.

Additionality

There has been a surge of criticism about the lack of additionality of a substantial proportion of CDM projects[1]. Project developers openly communicate that for most projects the CDM is a subsidy but is not decisive in the decision to proceed with the project. Given that about 3 billion CERs are expected to be generated by 2012 and many industrialized countries rely on the CDM to meet their targets, the current failure of the CDM substantially undermines the environmental integrity of the Kyoto Protocol.

This problem is not a matter of failed implementation but has its roots in the basic design of the mechanism, where projects are evaluated against a hypothetical baseline which cannot be observed. Considering the complexity of project development decisions, in many cases even project developers are unable to identify the make-or-break factors on which the development of a project depends. Considering also the subjectivity involved in such decisions, it becomes impractical in most cases for developers to "prove" their own motivations, and for auditors to accurately assess these motivations.

The most commonly used additionality arguments are unverifiable:

- ***Investment analysis*:** The most common argument to financial additionality is to show that the CDM brings the financial returns of a project up to an investable level from a non-investable level. Financial returns, especially since they are future projections, can be easily manipulated by modifying project assumptions such as expected capacity factor or tariff rate for a power generation project.
- ***Barrier analysis*:** Barriers assessments are also highly subjective. A project can demonstrate additionality by showing that substantial barriers to the implementation of a project exist. But, for example, most energy sector projects built with or without CDM support face barriers that could pass the CDM barriers test.

The invisible hand

Both buyers and sellers want the number of CERs generated by a project to be as high as possible, regardless of the additionality or the sustainable development impacts of the projects.

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[1] Haya B. (under preparation) *Measuring emissions against an alternative future: fundamental flaws in the structure of the Kyoto Protocol's Clean Development Mechanism (CDM)*, Berkeley, CA estimates that only a small fraction of CDM projects are additional;

Schneider L. (2007) *Is the CDM fulfilling its environmental and sustainable development objectives? An evaluation of the CDM and options for improvement*, Öko-Institut, Berlin, estimates that approximately 60% of CDM projects are additional;

Wara M.W. and Victor D.G. (2008). *A realistic policy on international carbon offsets. Rep. PESD Working Paper #74*, Program on Energy and Sustainable Development, Stanford University, Stanford, CA, estimate that a fraction of CDM projects are additional.

Therefore, the rules, procedures and oversight of the CDM governance bodies are essential to avoid the non-legitimate issuance of CERs. This makes it imperative for there to be rigorous validation and verification of CDM projects such as by accredited certifiers. To date, the work of these certifiers is of poor quality and lacks transparency, as indicated by the decision of the EB to put Det Norske Veritas's (DNV) accreditation on hold.

Effectiveness

For desirable projects, such as emerging renewable energy technologies and demand-side energy efficiency, project-based offsetting mechanisms do not provide funds cost effectively and have not been effective at changing project development decisions. This is due to high levels of risk and uncertainty at various stages of the project development cycle, as well as unnecessarily high transaction costs and levels of complexity:

- CER revenues involve numerous uncertainties, including: project registration and CER verification processes, CER price, and the numbers of CERs generated through following the baseline methodology.
- As a result of the risks, banks often do not take CER revenues into account when deciding on giving a loan to a CDM project. This makes the CDM ineffective at helping developers access debt financing, a critical factor for many projects.
- Funds are usually not provided at the start of a project when they are most needed, but instead are a revenue source through the life of a project. While there are some purchasers who can provide up-front payment, they generally do so in exchange for a lower CER price.
- The need to test project additionaltiy, an inherently inaccurate test, not only adds uncertainty to the CDM, but also adds high and unnecessary transaction costs that make the CDM less likely to affect decisions to go ahead with a project, especially for smaller projects. Moreover, a large portion of these costs is incurred before the start of the project and thus further exacerbates the up-front financing problem.
- For most types of projects, current carbon prices are too low to have a decisive effect on project financial returns.

Perverse incentives

The CDM could in fact lead to an increase in emissions in developing countries by providing perverse incentives to maintain a high baseline in order to be able to claim a larger number of credits. Such perverse incentives could be most damaging if they were to dissuade governments from enacting climate-friendly policies.

Sustainable development

The CDM also has not fulfilled its goal of supporting sustainable development. The literature on the CDM comes to the conclusion that the CDM has had little or no effect on achieving sustainable development in developing countries[2]. On the contrary, some of the projects in the CDM pipeline produce substantial social and environmental harm. In addition, despite the adoption of the Nairobi framework, too few projects are being implemented in least developed

[2] For example, Sutter and Parreño find that among their sample of CDM projects, only 1.6% of CERs were issued to projects with sustainable development benefits (Sutter C. and Parreño J.C. (2007) "Does the current Clean Development Mechanism (CDM) deliver its sustainable development claim? An analysis of officially registered CDM projects," *Climatic Change* 84).

countries. Institutional barriers prevent small-scale projects, including those in rural areas and at the household level, from being registered. Lastly, many projects are approved which represent marginal improvements at best upon past practices (such as coal-fired power plants with cogeneration). These projects represent a failure to pursue the best options in terms of sustainable development and environmental integrity, such as emerging renewables and demand side energy efficiency projects; and in some cases, such as waste management, are in direct conflict with better projects.

Low hanging fruit

CAN is concerned that the CDM will capture the cheapest mitigation options in developing countries to be applied towards Annex I targets, rather than contributing, with support from Annex I countries, to a "substantial deviation" of emissions from BAU in non-Annex I countries. Any reform of the CDM should only credit actions that go beyond low cost or win-win options, though it might be necessary to give special consideration in case of LDCs, SIDs and Africa.

The Ecological Limits of Offsetting

The future role of the flexible mechanisms needs to be seen in the context of the current state of climate science. CAN's position is that to minimize the harmful impacts of climate change, global average temperature increase should be kept as far below 2°C as possible.

The lowest stabilization scenarios assessed by the IPCC so far foresee stabilization of atmospheric GHG concentrations at 445-490 ppm CO_2eq, which would lead to an average temperature increase of 2.0 to 2.4°C. To increase the likelihood of staying below 2.0°C, stabilization of global concentrations below 400 ppm CO_2eq is required.

The IPCC Fourth Assessment Report shows that stabilization at even 450 ppm requires reductions by Annex I countries in the range of 25-40% compared to 1990 levels by 2020. **In addition to** this reduction in industrialized countries, a "substantial deviation" from business-as-usual in non-Annex I countries is required. Although the IPCC report did not quantify the "substantial deviation" necessary, a recent paper by den Elzen and Höhne, the authors of the IPCC ranges table, quantifies this "substantial deviation" at 15% to 30% below baseline.

Therefore, credited actions in non-Annex I countries must not replace ambitious domestic emission reductions in Annex I countries; a large majority of the close to 40% Annex 1 reductions must be made domestically.

Attachment 2:
REVIEW OF OPTIONS FOR CDM REFORM

In the following, CAN provides its position on many of the options for reforming the flexible mechanisms laid down in Annexes I and II in documents. FCCC/KP/AWG/2008/5 and FCCC/KP/AWG/2008/INF.3

A. Inclusion of other land use, land-use change and forestry activities.

SUMMARY: CAN does not recommend the inclusion of LULUCF project types beyond the existing afforestation and reforestation category, and does not support the inclusion of REDD in the CDM.

CAN has repeatedly pointed out the problems with LULUCF activities in the CDM; in particular we have voiced concerns about non-permanence of emission reductions from sinks projects, the issue of project boundaries, carbon leakage and lack of safeguards for biodiversity and land rights issues. These concerns (combined with the observation that currently only one such project is registered under the CDM) strongly suggest that project-based mechanisms like the CDM are not the right place for LULUCF activities. Therefore, CAN not only opposes the inclusion of LULUCF activities beyond the existing afforestation and reforestation category in the CDM but also recommends that the structure of the current CDM A/R is revised in advance of the second phase of Kyoto based on these concerns. In addition, the CDM is clearly not the appropriate tool for addressing emissions from deforestation and forest degradation in developing countries (REDD). The scale of activities and support needed for REDD is beyond the scope of the CDM and the CDM provides inadequate safeguards for Indigenous Peoples and Local Communities, biodiversity, and sound governance. A system separate from the CDM should be designed specifically for REDD that delivers significant and reliable streams of funding for emissions reductions from deforestation and forest degradation that are measurable, reportable and verifiable, and contributes significantly to the mitigation of dangerous climate change.

Given these concerns, and in association with the general problems with the CDM as outlined in the first part of this document, CAN opposes the inclusion of any activities that would extend the scope of LULUCF within the CDM.

C. Inclusion of carbon dioxide capture and storage

SUMMARY: CAN does not support the inclusion of CCS in the CDM.

According to the Marrakesh Accords, the inclusion of a project in the CDM requires demonstration that the use of the technology will be environmentally safe and sound. With only a few existing demonstration projects, CCS technology still needs to adopt requirements for selection, operation and monitoring of CCS projects. Thus it does not fulfill the requirements for inclusion to the CDM according to the Marrakesh Accords. There are a number of unresolved issues. For example, the chemical and physical behavior of CO_2 injected into geological formations is unknown. Additionally, CCS has long-term implications: The time frame for the post-injection and post-closure stage can range from many decades to hundreds of years,

depending on storage site parameters. Other technical uncertainties, such as the possibility of leakage and the effectiveness of monitoring, make it difficult to assess the quantity of CERs that will actually be generated.

The CDM should be part of an overall strategy to help developing countries "leapfrog" an unsustainable fossil fuel economy. Support for renewables and energy efficiency are better investments, whose safety and effectiveness are well established. They are also much cheaper options than CCS. CAN believes that the CDM is not the appropriate forum for supporting the research and development needed to ascertain whether CCS is safe and effective.

The CDM should not be expanded, especially by a technology with the size and lifetime of CCS, while the CDM is still an offsetting mechanism, since overall absolute reductions are needed.

D. Inclusion of nuclear activities

SUMMARY: Activities related to nuclear power must not be allowed to become eligible for the Kyoto Protocol's flexible mechanisms.

A scenario published in 2008 by the International Energy Agency (IEA) illustrates that even a massive, four-fold expansion of nuclear power by 2050 would provide only marginal reductions (4%) in greenhouse gas emissions, while at a minimum global emissions should peak by 2015 with 50-85% cuts by 2050.

The greenhouse gas abatement potential of both energy efficiency and renewable sources is many times higher than that of nuclear power. Those solutions, unlike nuclear power, can be implemented in a timely manner and without serious collateral hazards such as nuclear accidents, radioactive waste and proliferation.

Further, high capital costs and negative impacts on global security and sustainable development make investments in nuclear energy an obstacle to the necessary development of effective, clean and affordable energy sources – both in developing and industrialized countries.

Activities related to nuclear power must not be allowed in the CDM in order to avoid:

- Undermining climate protection by taking away precious resources from more effective and clean solutions;
- Dumping of nuclear technologies – the most expensive and unsafe of available technologies – on developing countries who would be burdened with the associated economic and environmental impacts (accumulation of massive financial debts, increased dependency on foreign fuel and technologies, increased risk from reactor accidents and contamination); and
- Decreasing global security due to a strong increase in radioactive waste volumes for which there are no safe disposal solutions and an increased risk of proliferation of nuclear materials.

E & F. Introduction of sectoral clean development mechanism for emission reductions below a baseline defined at a sectoral level and introduction of

sectoral crediting of emission reductions below a previously established no-lose target

SUMMARY: For countries without QELROs, sectoral no-lose targets set well below business-as-usual projections with support from Annex I countries for lowering emissions to the target level merit further consideration. To ensure that this approach solves both the offsetting and additionality problems, the following issues would need to be considered. Given uncertainty in business-as-usual projections, ambitious no-lose targets are needed to avoid non-additional credits, windfall-profits and other market distortions. Ambitious targets are also needed to assure that reductions within the "substantial deviation" needed in developing countries do not also contribute to reduction obligations in industrialized countries. Such targets would need to be accompanied by MRV support to help participating developing countries achieve those targets. Such MRV support is essential to a sectoral crediting mechanism with ambitious targets. Sectoral baselines or sectoral no-lose targets would necessitate having access to detailed and reliable emission inventories: the experience of the first phase of the EU Emissions Trading System underscores the importance of accurate information. At the moment, probably only a few developing countries possess the necessary technical capacity and probably only for a limited number of industrial sectors. Significant capacity building prior to implementation would be required.

In terms of **measuring and verifying emissions and reductions**, crediting below sectoral baselines and crediting below sectoral no-lose targets are very similar. The main difference would be that the first option continues the baseline-and-credit approach of the current CDM, whereas in the second option targets would be politically negotiated. This second option therefore opens the possibility of setting a target well below the projected baseline level and achieving a net atmospheric benefit, which is a positive feature. By contrast, under the first option the CDM would continue to be a zero-sum game at best.

A further positive feature of both options is that they would move away from assessing the baseline and additionality for individual investment decisions, which, as discussed above, is not logically possible for most cases.

However, the quantification of emissions and reductions at the sectoral level would have to rely on a solid understanding of the current and expected trends in the emissions of the sector in order to ensure the target is established well below business as usual. One such way of ensuring such a framework is to use emissions modeling and projections, which always possess a degree of uncertainty. Depending on the models used, projections at an aggregate level may be more reliable than project-by-project additionality testing, but they might be even less reliable. Sectoral crediting based on unreliable projections would lead to large amounts of non-additional credits. It is therefore imperative to assess the reliability of quantifying developing country reductions at the sectoral level before scaling up uncapped trading.

In any case, establishing a robust sectoral baseline or sectoral no-lose target would necessitate having access to detailed and reliable emission inventories for the host countries or at least for

the sectors covered. The reliability of the emissions monitoring would also need to be ensured. At the moment, probably only a few developing countries possess the necessary technical capacity. Sectoral no-lose targets would therefore either require significant capacity building prior to implementation or would exclude many developing countries.

There is substantial uncertainty regarding growth rates in many carbon-intensive sectors and industries in developing countries, which makes it challenging to determine an absolute target. The current economic crisis reminds us that outside factors can strongly influence sectoral emissions. To avoid restricting high economic growth and to avoid windfall profits and collapsing CER prices in cases of low economic growth, sectoral targets could be either intensity targets or combined with a factor to dynamically adjust the absolute target to GDP growth. A challenge posed by dynamic targets is that it provides much less control over actual emissions.

In terms of providing an **incentive for low-carbon development**, it is probably the case that the incentives created by a no-lose target would not primarily arise from the ability to sell carbon credits, but instead would result from the focused effort of both industrialized countries and participating developing countries to bring sectoral emissions down to the target level and then beyond. Therefore, sectoral targets alone are not likely to be enough to create incentives for significant low carbon development. No-lose targets should be set well below business-as-usual projections along with commitments by Annex I countries to provide substantial support to help countries bring their sectoral emissions down to the target level. Such support is an essential part to this proposal.

Sectoral mechanisms are being pursued with the explicit aims of: (1) being able to tap non-Annex I mitigation potential at a much larger scale than the current CDM is able to; and (2) create conditions for more rapidly developing countries to join international emission trading efforts. While a scaling up of support for climate change mitigation in developing countries is critical to the post-2012 regime, this must not be done at the expense of domestic reductions in industrialized countries. Therefore either industrialized country targets will need to be substantially deeper, to accommodate the scaled up mitigation support through the generation of credits, or developing country targets will need to be set at levels that are well below business-as-usual with MRV support from Annex I countries. No-lose targets will likely be subject to political negotiation, at risk of resulting in non-robust targets.

Another critical issue is the ratio between supply and demand of carbon credits. The updated financial flows paper by the Secretariat projects the demand for credits in 2020 to be 0.5-1.7 Gt CO_2eq. By contrast, the mitigation potential in 2020 in developing countries is estimated at about 7 Gt CO_2eq. If not designed carefully, a post-2012 regime with weak Annex I targets and a wide scope for sectoral mechanisms could easily result in a drastic oversupply of the carbon market.

G. Introduction of crediting on the basis of nationally appropriate mitigation actions

SUMMARY: Elaboration of the suite of NAMAs that a developing country plans to implement should be supported, but the CDM is most likely not the right

mechanism to support all but a limited number of these actions. The definition of this proposal is still unclear, so it is difficult to comment on it until it has been further elaborated. Concerns about the inclusion of NAMAs in the CDM include uncertainties in quantifying the emissions reduced by NAMAs, difficulty assessing the additionality of NAMAs, and from the experience of the first commitment period, there are obvious limitations on the types of NAMAs a crediting mechanism could incentivize. Further elaboration of South Africa and South Korea's proposal on the registry of NAMAs might help clarifying the suitability of CDM as a support mechanism for NAMAs.

This proposal is not well defined and so it is difficult to comment on it until it is further elaborated. We understand this option to retain the current CDM approach of crediting individual actions such as policies and sector-wide programs, in contrast to the previous two options, which would credit the aggregate performance of whole sectors. The following comments are based on this understanding.
As with the previous two options, quantifying emissions and reductions would need to rely on modeling and projections. The challenge would probably be even more complex, though, since NAMAs would be implemented in complex environments and isolating the emission reduction effect of a given NAMA from impacts of external factors such as other climate-related government activities, changes in fuel prices etc. may in many cases be far from straightforward.

Crediting NAMAs would have the same limitations as the previous two options in terms of being unable to predict the carbon revenue and the potential mismatch of supply and demand.

Additionality testing would be even more difficult with NAMAs than with projects. Programs and especially government policies are often implemented for a range of reasons for which there are few metrics that can be used to predict their implementation.

Additionally, using the CDM as a vehicle to deliver support for NAMAs in developing countries according to the Bali Action Plan has some severe shortcomings: First, the CDM only promotes short term and measurable greenhouse gas reductions and thus would leave out many forms of NAMAs including capacity building, research and development that are crucial, especially in least developed countries.

Further, relying on the CDM for providing measurable, reportable and verifiable (MRV) finance to support nationally appropriate mitigation actions by developing countries would exclude those Annex I countries that do not purchase CERs (for example, because they are not parties to the Kyoto Protocol) from contributing to that support. In general, therefore, it would be better to seek a new mechanism for MRV finance for NAMAs under the Bali Action Plan. In this respect, South Africa and South Korea's proposal on the registry of NAMAs in the context of AWG LCA is worth exploring. The further elaboration of this idea might also help clarify the suitability of the CDM as a support mechanism for NAMAs.

I. Ensure environmental integrity and assess additionality through the development of positive or negative lists of project activity types

SUMMARY: CAN believes that a small positive list that entirely replaces project-by-project additionality testing could theoretically address the additionality problem, but is likely to be unworkable in practice. Namely, the selection of project types for the list will be controversial and subject to pressure from both private industry and the parties. A positive list that complements project-by-project additionality testing would not solve the existing flaws and is therefore of little use. CAN does support the use of a negative list to avoid the worst project types, but this alone will not address the fundamental problems in the current CDM.

Two variations on the positive list have been proposed. In the first, the list would complement project-by-project additionality testing. Project types which are on the list would be deemed to be additional by nature and would not be subject to additionality testing. Obviously, only project types which are always (or almost always) additional would be eligible for such a list. In essence, a complementary positive list would be a fast-track approval method for certain project types, while leaving the approval process for other project types unchanged. Since these other projects would still be required to undergo individual additionality testing, this approach would not address the fundamental additionality flaw in the current CDM. As such, CAN does not support a complementary positive list.

The second version of the positive list would be a replacement for project-by-project additionality testing. Project types on the list would be eligible for credits; those not on the list, ineligible. While in theory, this could provide an alternative to project-by-project additionality testing, in practice it is likely to be unworkable. This is simply because the selection of project types for the list will be extremely controversial and subject to intense pressure from both private industry and the parties. Neither the CDM nor the parties have so far shown the necessary mettle to resist including inappropriate project types, and so it is reasonable to expect that the list will quickly grow to include many project types which are non-additional. This will defeat the purpose of this type of positive list. In addition, this type of positive list would be unable to deal with project types which include significant numbers of both additional and non-additional projects. A small, stringently-defined positive list that excludes such mixed project types would be unlikely to win support from the parties; a broad positive list that includes them would undermine the treaty goals and possibly be worse than the current system.

A **negative list** would not address either of the fundamental flaws in the CDM. However, in conjunction with other reforms to address those problems, it would be useful to ensure the CDM avoids subsidizing the worst project types. This practice is followed by many major international organizations, including the multilateral development banks. CAN would support the adoption of a negative list in conjunction with other fundamental reforms. The below list of activity types should be included in a negative list, if the reformed CDM continues to take the form of a project-based mechanism.

- Nuclear
- Large hydropower
- Waste incineration
- Carbon Capture and Storage
- Coal
- Unsustainable or chemical-treated biofuels
- Unsustainable or chemical-treated biomass/biochar
- Ocean fertilization and other forms of geoengineering
- HFC production
- Any project requiring resettlement or which deprives indigenous people of their customary use of land.

L. Include co-benefits as criteria for the registration of project activities

One of the two goals of the CDM is the promotion of sustainable development of the host countries. CAN is therefore strongly in favour of option 2: that projects shall demonstrate specific co-benefits as a requirement for registration. In particular, the CMP should decide that all CDM projects must meet social and environmental standards such as those laid out in the CDM Gold Standard. The assessment of the sustainable development contribution of projects should be undertaken by independent institutions such as DOEs (if selected and paid by UNFCCC).

In addition, community- or household-based projects are hardly included currently in the CDM, whilst there is a huge potential for such projects especially in LDCs. To enable such projects, the CDM should make it easier for the smallest projects to register, including with:

- Simplified registration procedures for micro projects (<15,000 tonnes CO_2eq/year) in rural areas and at the household level.
- Improved funding conditions for community- or household-based projects, e.g. by a creating a CDM bank providing up-front funding, guaranteeing fixed and high CER prices and grants for transaction costs.
- Accrediting specialized certifiers to ensure a timely validation and verification process.

M. Introduce multiplication factors to increase or decrease the certified emission reductions issued for specific project activity types

SUMMARY: CER discounting could improve the environmental integrity of any of the other options discussed in this position paper, but even in combination would not solve the two main problems of the CDM. If discounting were allowed to justify a weakening of additionality testing, it would exacerbate the CDM's problems. Importantly, it will be difficult to assess the percentage of projects that are non-additional, and discount rates are unlikely to be low enough to compensate for the proportion of non-additional CERs in the current CDM.

CER discounting could improve the environmental integrity of any of the other options discussed in this position paper, but even in combination would not solve the two main problems of the

CDM. If discounting were allowed to justify a weakening of additionality testing, it would exacerbate the CDM's problems.

Ideally, discounting could make it more likely that CERs represent real emissions reductions, and further, that the CDM moves beyond being a zero-sum game to making real reductions. In practice, there are serious challenges to bringing this about.

Considering that it is possible that only a fraction of CDM projects are truly additional as some researchers have estimated[3], and that the CDM has not been very effective at supporting projects in real need of support, even with discounting the CDM still runs the risk of continuing to generate more credits than are actually reduced. Discounting could also unnecessarily punish truly additional projects, which are already difficult to implement.

Further, to the extent that the CDM is expanded, even with discounting, it runs the risk of generating large amounts of credits allowing industrialized countries to avoid making the large majority of their emissions reduction commitments domestically. Similarly, the use of discounting could justify weaker additionality testing, which could negate the potential positive effects of discounting on the proportion of non-additional projects.

Just as it is very difficult to test the additionality of a single project, and since growth projections across sectors historically have not been very accurate, forecasting the percentage of business-as-usual projects in any given sector could potentially be very inaccurate. Further, discount rates will be politically negotiated based on these forecasts. To the extent that different technologies and countries will have different discount rates, there is risk that the negotiating process will result in weak discount rates that fall short of contributing to environmental integrity.

If discounting were implemented, it should meet the following requirements:

- The discount rate would need to be set well below a conservative estimate of the amount of business-as-usual emission reductions (i.e. non-additional CERs) in order both to compensate for the net increase in global emissions that results from non-additional CERs and to provide a net benefit to the climate, thus "moving the CDM beyond offsetting," as long requested by CAN.
- Discounting rates must be predictable at the start of a project or program, to avoid adding more complexity and uncertainty to the CDM cycle.
- The CMP or another competent body should commission independent research to review the environmental integrity of the CDM by assessing the portion of certified business-as-usual emission reductions.
- Another potential for CER discounting could be to control the windfall profits from activities that reduce emission of gases with exceptionally high global warming potential, as has occurred with HFC 23/N_2O CDM projects, which have been criticized of being an inefficient way of reducing emission of those gases and which also produced perverse incentives.

[3] See Haya B. 2007. *Failed Mechanism: How the CDM is Subsidizing Hydro Developers and Harming the Kyoto Protocol*, International Rivers, Berkeley, CA;
Wara M.W., Victor D.G. 2008. *A realistic policy on international carbon offsets. Rep. PESD Working Paper #74*, Program on Energy and Sustainable Development, Stanford University, Stanford, CA