

**SYNTHESIS REPORT  
OF THE CALL FOR INPUT ON THE  
CDM POLICY DIALOGUE**

Note by the secretariat

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## EXECUTIVE SUMMARY

This document synthesizes the main elements of the submissions received in response to a call for inputs issued by the Executive Board of the Clean Development Mechanism (CDM EB) on launching the CDM Policy Dialogue.

The above call invited submissions on the scope of the CDM Policy Dialogue. It was open from October 2011 to 21 January 2012. Fifty-eight submissions were received.

Based partly on the structure of some of the submissions, the concerns/issues/topics expressed were gathered around five main clusters:

- *Governance of the CDM*: shortcomings and challenges of the current arrangements;
- *Methodologies and Processes*: inadequacies of the current guidelines on additionality assessment and baseline determination;
- *Sustainable Development*: lack of meaningful stakeholder participation in assessing projects, along with concerns over sustainable development definitions and environmental and social implications of CDM projects;
- *Trade and Finance*: trade implications of the CDM, as well as implications for wider financing issues related to the transition to a low carbon society; and
- *Architecture of the CDM*: its context, relation to the Kyoto Protocol, to the new climate regime post-Durban and to emerging carbon market instruments.

### Governance of the CDM

Numerous submissions called for the Policy Dialogue to address the arrangements by which the CDM is governed, expressing concerns about a perceived lack of transparency and professionalism in the governance system.

There was recognition in some submissions of the large degree of variation in technical skills and capacity across different bodies and stakeholders. One particular criticism, noted in the call for input, was the lack of training and capacity development across the major stakeholders, including potential and actual project developers, or affected communities at the local level. Over time, the roles prescribed in Kyoto and Marrakesh have changed with the onset of practice and the unexpected success of the CDM, measured in terms of project submissions. This unexpected success has led to a forced and un-programmed re-arrangement of roles, as structures have tried to cope with the demands of a far more intense workload than was previously envisaged.

Despite existing provisions to ensure **transparency of decision-making** by the CDM EB and other institutions, there have been repeated complaints about the closed nature of much of the decision-making at CDM EB and panel/working group (WG) level. This lack of transparency and access to CDM EB decisions and their closed nature, has led to the perceived need **for an appeals or grievances mechanism** for decisions adopted by the CDM EB.

In relation to the **election and composition of the CDM EB**, some stakeholders would like to see a CDM EB elected on the basis of merit, rather than proximity to the negotiating process. Gender balance in the CDM EB was also raised as an issue.

With respect to the role of the designated operational entities (DOEs), claims exist that the system may lead to inherent **conflicts of interest**. Some stakeholders argue that, given that DOEs are funded by their clients who have a keen interest in securing positive validation and verification opinions, this impacts on the independence of DOEs. Suggestions have been

made to make the selection of the DOE independent from the project participant.

### Methodologies and Processes

CDM methodologies provide the guidelines for the assessment of additionality, the identification of the baseline scenario, and the calculation of emission reductions in any CDM project. As with the projects themselves, methodologies have been developed over the years by project developers intent on using the CDM in a given context for which there is no approved methodology available. Over the last 10 years, project developers have submitted more than 450 blueprints of methodologies, of which the CDM EB has approved approximately 200, including those methodologies developed top-down by the working groups of technical experts. While recognizing that much has been done, at the same time there is much criticism of the methodology development process, of the additionality assessment used in most methodologies, and of the sectoral scope emphasised by the current list of applicable methodologies.

On the approach on **additionality**, there has been criticism of the approaches used in most CDM methodologies and estimates of a high proportion of non-additional projects in the CDM pipeline. This criticism has been reflected in some of the submissions and several stakeholders from different interest groups have put forward alternative approaches to additionality.

On **baselines**, much of the input received notes the costs of developing CDM projects with the current set-up of individual baseline calculation for each individual project and asks for an acceleration of the deployment of standardized baselines. i.e. baselines which represent a generic situation in a country or a sector, whilst alerting to the potential dangers to the environmental integrity of the mechanism stemming from ill defined and not-so-conservative standardised baselines. Concern was expressed by one stakeholder regarding the approach taken by the CDM EB so-far in the development of standardized baselines.

Concerns have also been expressed in relation to a set of **perverse incentives** that the CDM may be putting in place.

Whilst some stakeholders note that there has been an improvement of performance of the CDM EB and secretariat in managing the pipeline of submissions, there have been requests for **further streamlining processes**. The High-Level Panel is urged to conduct consultations to look into opportunities to increase overall efficiency of the system, streamlining and automating processes where feasible.

### Sustainable Development

An enduring discussion under the CDM is that of the Mechanism's **contribution to sustainable development**. Under the CDM, there is no agreed definition of sustainable development. Many stakeholders emphasize the lack of definition of sustainable development in the context of the CDM, which may lead in a competitive instrument to a lowering of the standards. The reliance on the designated national authorities (DNAs) may also increase that pressure, as many DNAs may not be well equipped to define and assess the host country's priorities in its sustainable development. The High-Level Panel has therefore been urged to do an in-depth assessment of the role and practice of the DNAs in relation to sustainable development, for example by assessing the use of sustainable development indicators in the DNA project assessment, or by considering the introduction of a "no harm" assessment.

Civil society organisations have expressed repeatedly, including in the input received, inadequacies with the current system of **public participation** by stakeholders. The current provisions are, according to some stakeholders, not allowing for the full and most effective participation of stakeholders, in particular at the local level.

Stakeholders have also raised the issue of **human rights**. Recently, the CDM EB was confronted with allegations of human rights violations as a result of proposed CDM project developments. The CDM EB responded by stating that it did not have the mandate to conduct investigations on human rights abuses. Several of the inputs claim that this may be too narrow an interpretation of its own mandate, and that the issue might be covered by the CDM EB's responsibilities vis-à-vis the Charter of the United Nations.

### Trade and Finance

Some stakeholders believe that the level of transaction costs involved in the development of CDM projects to date has severely stunted the possibilities for truly transformational levels of finance.

Some stakeholders urge the High-Level Panel to look into ways of maximizing any potential leveraging impact the CDM may contribute to the deployment of climate finance.

“Carbon leakage” refers to the scenario that companies exposed to carbon constraints in Annex I (for example, in the European Union carbon market) may choose to relocate or increase their emissions outside Annex I. By subsidizing emission reductions outside Annex I in sectors in competition with Annex I companies, this effect may be reinforced by the CDM. The net effect of CDM could eventually even be negative. The High-Level Panel is asked by some stakeholders to investigate such carbon leakage and its extent, if any.

### Architecture of the CDM

The CDM is an integral part of the Kyoto Protocol and was conceived as an instrument to pursue the twin objectives of sustainable development in host countries and cost-effective mitigation opportunities in compliance with emission reduction targets by developed countries under the Kyoto Protocol. One view propounded by several stakeholders, therefore, is that the **future of the CDM is tied to the future of mitigation efforts under the Kyoto Protocol**.

Some stakeholders look, however, to a **future CDM which may encompass other roles**. While not denying the initial role of the CDM as a tool in the compliance toolkit of Annex I Parties with targets under the Kyoto Protocol, they emphasize distinct features of the CDM – its role as a standard-setter for carbon offsets, or its potential use outside of the framework of the Kyoto Protocol.

While these broader views of the potential role of the CDM are expressed by some stakeholders, there is widespread recognition in the submitted material of the **lack of balance between supply and demand** in the current market for CDM, with some stakeholders urging measures, such as price controls (e.g. “minimum price floor”). The current developments in the market lead many to question the viability of the CDM if measures are not taken to address urgently the imbalance between supply and demand.

The Ad Hoc Working Group on the Durban Platform (ADP) was launched in Durban, with a view to completing by 2015 its work on “a protocol, another legal instrument or an agreed outcome with legal force under the Convention applicable to all Parties”. In addition, the Durban Conference of the Parties *defined* a new market-based mechanism, which may or may not overlap in scope with the CDM. Several stakeholders therefore would like to see a particular focus of the Policy Dialogue on **the role of the CDM in relation to this wider context**, both of the negotiations on carbon markets, and also of the development of national initiatives on carbon markets in several Annex I and non-Annex I Parties.

Some stakeholders note that the objective of moving to vastly decreased global carbon emissions must eventually mean that the **sole reliance in pure emission offsetting instruments** must eventually stop. Offsets are seen therefore as a transitional instrument

towards a world with vastly reduced emission budgets requiring emission reduction efforts globally.

### **Suggestions on Process**

Submissions received suggested ways in which the High-Level Panel could organize its work. These included a suggestion to structure the work along an assessment of CDM performance in relation to its stated objectives, a discussion of challenges and shortcomings, and an analysis of the potential role of the CDM post-2012. Another suggested approach was for the High-Level Panel to use its first meeting to narrow the focus of its work, and then to seek more targeted input from stakeholders on the issues selected.

Finally, several stakeholders highlighted the need to ensure that the proceedings of the High-Level Panel are open, transparent and participatory.

## I. Introduction

1. At its sixty-fourth meeting in October 2011, the Executive Board of the CDM (CDM EB) agreed to the Terms of Reference for the Policy Dialogue, considered issues to be included in the dialogue and agreed to launch a call for public inputs on the scope of the dialogue.
2. The call resulted in 58 submissions from a wide variety of stakeholders, ranging from intergovernmental organizations (such as the World Bank and several United Nations agencies) to carbon market participants and civil society organizations, to submissions from individuals. In addition, there was a reasonable variety in the regional background of the submissions. Breakdowns of the submissions are shown in figures 1 and 2.

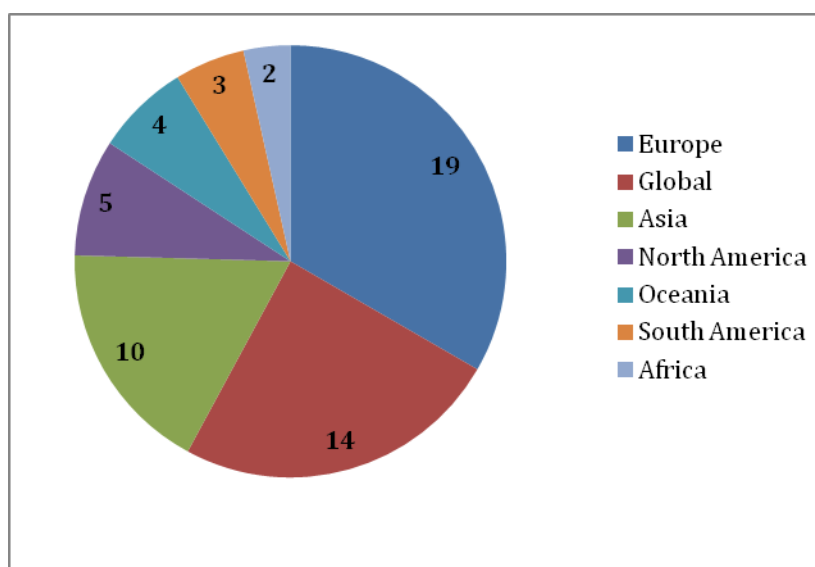


Figure 1 – Regional breakdown of submissions

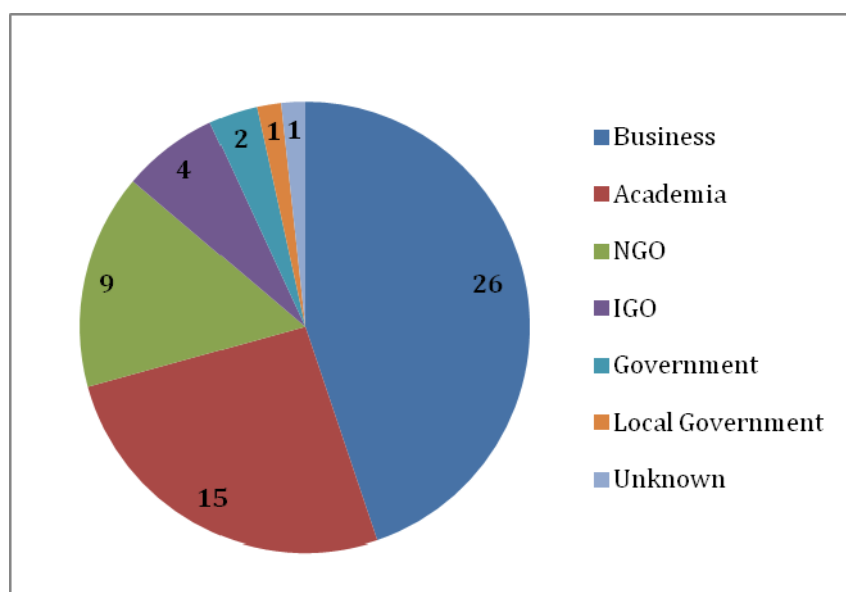


Figure 2 – Breakdown by stakeholder type

3. It should be noted that despite the variety of submissions received, the range of submissions received might not reflect the full range of views on the CDM. As an

example, only one submission was received from a Designated National Authority (DNA), a key stakeholder in the CDM project cycle.

## **II. Analysis of submissions by main topics covered**

4. Submissions received covered a wide range of topics and a number of possible classification schemes could have been presented. Based partly on the structure of some of the submissions, the concerns/issues/topics expressed were gathered around five main clusters:
  - *Governance of the CDM*: shortcomings and challenges of the current arrangements; including issues related to the election and composition of the CDM EB, transparency of the proceedings and decisions, issues of conflict of interest within the designated operational entities (DOEs) and, lack of an appeals or grievance mechanism;
  - *Methodologies and Processes*: inadequacies of the current additionality and baseline assessment, including lack of standardisation and the issue of perverse incentives in relation to national policies;
  - *Sustainable Development*: concerns over the lack of meaningful stakeholder participation in assessing projects, along with concerns with sustainable development definitions and environmental and social implications of CDM projects;
  - *Trade and Finance*: concerns expressed as to the trade implications of the CDM, as well as implications to wider financing issues related to the transition to a low carbon society; and,
  - *Architecture of the CDM: what next for the CDM*: its context, relation to the Kyoto Protocol, to the new climate regime post-Durban and to emerging carbon market instruments.
5. The next sections contextualize and provide further detail on the topics identified in the submissions.



## 1. Governance of the CDM

### A simple description of the governance system of the CDM and its evolution

6. The governance system of the CDM encompasses:
  - the Conference of the Parties serving as the Meeting of the Parties to the Kyoto Protocol (CMP);
  - the CDM EB, tasked with the supervision of the mechanism, including the adoption of methodologies, the registration of projects and the issuance of credits (known as “certified emission reductions” or “CERs”);
  - Panels and working groups, assigned to specific tasks by the CDM EB and supervised by it. These are the Methodologies Panel (Meth Panel), the Small-Scale Working Group (SSC WG), the Afforestation and Reforestation Working Group (AR WG), and the Accreditation Panel (CDM-AP);
  - Designated Operational Entities (DOEs), tasked with validating projects and verifying emission reductions as compliant with CDM rules;
  - Designated National Authorities (DNAs) in each Party, required to approve the participation of private entities in a project and, in the case of host countries, are further tasked with approving the project and certifying that it contributes to the sustainable development of the country; and
  - the secretariat of the UNFCCC, in particular its Sustainable Development Mechanisms programme, assigned to support to the CDM EB and other CDM-related structures.
7. Over time, the roles of the different entities within the governance structure have changed with practice. The CDM EB has taken a more hands-on approach to the whole supervision of the mechanism, with approximately seven week-long meetings per year. DOEs have seen their work scrutinized intensely by the CDM EB, on a project-by-project basis. The secretariat has taken on other roles not originally envisaged. For example, the review of submissions of validation and verification reports by DOEs has, over time, been outsourced because as the number of submissions grew exponentially, the CDM EB was unable to keep up with the sheer volume of submissions. Initially, in order to cope with the volume, the CDM EB established a Registration and Issuance Team (RIT) composed of approximately 20 to 30 individuals who reviewed submissions and reported on their opinion. Separately, the secretariat was also tasked with providing its opinion, and the CDM EB was then able to decide on the basis of two separate and independent opinions on the quality of the work of the DOE and the appropriateness of the validation or verification opinion. This cumbersome review process was overhauled by the CDM EB in 2010, with a view to processing submissions more effectively and in a timelier manner, prompted by inputs received from many stakeholders involved in project development.
8. Beyond the realm of review of registration and issuance cases, the secretariat has taken on a much more active role in the management of the CDM and in assisting the CDM EB. The secretariat now provides briefings and drafts of all major documents elaborated by the CDM EB, organizes much of the work of the panels and working groups, and coordinates with forums such as the DNA forum and other stakeholder units as compared to a couple of years ago.
9. The success of the CDM has therefore led to a forced re-arrangement of roles, as structures tried to cope with the demands of a far more intense workload than previously envisaged.
10. One particular criticism in relation to the different stakeholders in the CDM processes is the uneven, and in some cases poor, level of performance of different actors, whether

it is the CDM EB, the DOEs, the DNAs or even the project participants themselves. There have been requests in the past, and again in the call for inputs, for more training and capacity development across major stakeholders.

*“However, at CMP7 [the Durban climate conference in 2011], Parties requested the EB to provide further training to DNAs, DOEs and project participants. This is a great opportunity for the EB to now ensure that all stakeholders (including the Secretariat and RIT members) in the CDM are able to receive the same training on the interpretation of guidance from the CDM EB.” Project Developer Forum (submission no. 14)*

### Lack of transparency

11. Despite provisions to ensure transparency by the CDM EB and the secretariat, there have been repeated complaints about the closed nature of much of its decision-making. In effect, mostly for reasons of confidentiality (and the lack of a system of immunities from prosecution), all case-related sessions of the CDM EB are closed to the observers. That leaves only those sections of the meetings dealing with policy-relevant matters open to the public, but even those have, at times, been deemed too sensitive to be made open.
12. The impression of the closed nature of the governance structure and its lack of transparency is also seen by some stakeholders in the fact that the CDM EB and its support structures, until recently, did not appear willing to engage with stakeholders beyond briefings at the sessions of the CMP. In addition, stakeholders also complain that, in relation to several important decisions, whether case-related or policy-relevant, the rationale for the decisions taken was not published. Finally, the use of English as the sole official language of the CDM introduces a potential bias towards those stakeholders with a better command of the language. In the case of local stakeholders, this may preclude adequate participation or consultation.

*“The CDM has become over the last years much more efficient. However there are still efficiencies to be extracted out of CDM, especially in the areas of communication and governance.” CEPS (submission no. 17)*

*“The decision-making processes, specifically those of the Executive Board with respect to policy, are a source of frustration to stakeholders and are an impediment to the future of the CDM. The CDM Policy dialogue must consider the transparency of the decision making processes and how the Executive Board can better consider the views of stakeholders, and ensure that policy decisions are timely and promote confidence in the mechanism for all participants.” AIGN-Business Council Australia (submission no. 18)*

*“One great challenge to participating in CDM has been the near constant reinvention of CDM rules. This practice continues to the present with, for example, the newly introduced Project Standard” Jessica de Jimenez (submission no. 15)*

### The lack of an appeals or grievances mechanism

13. The lack of transparency and access to the CDM EB and the closed nature of their decision-making process has resulted in a perceived need by some stakeholders for an appeals or grievances mechanism related to CDM EB decisions on case-specific issues. The creation of such a mechanism has been under intense debate during the past two years of the intergovernmental negotiations. Progress has been made in relation to many features of such a mechanism, however negotiations are stuck on the scope of the appeals mechanism, for example, whether the appeals process should only allow appealing ‘negative’ decisions (i.e. rejections of registration and issuance requests) or also ‘positive’ decisions (i.e. approvals of requests for registration or issuance).
14. *Locus standi* (the right to make an appeal) of the appellate process is also an issue that figures prominently in some submissions as some stakeholders would be particularly keen to be able to appeal positive decisions (i.e. approval of registration or issuance cases). The perceived lack of appeal or redress for local communities is an issue for some stakeholders.

*“Having a functioning appeals process is critical to the credibility and future success of the CDM. If the CDM is to provide compliance grade credits for capped regimes, then it must be feasible for those regimes or stakeholders in those regimes, to appeal against individual projects. Failure to provide this opportunity places all the responsibility on the CDM EB, but currently they are unable to “de-register” a project or comment upon a project’s contribution to the host country’s sustainable development.” Project Developer Forum (submission no.14)*

*“It is therefore essential that project-affected peoples and civil society groups have the right to appeal decisions by the Board.” International Rivers (submission no.22)*

## **Election and composition of the CDM Executive Board**

15. UNFCCC constituencies, i.e. regional groups of Parties under the Kyoto Protocol, nominate CDM EB members and alternates. They are normally recruited from the pool of negotiators working on market mechanism issues under the Convention and the Protocol, as they are both closest to the nomination process and also seen by Parties to be the most capable of meeting their expectations. Several issues have been raised in relation to the CDM EB, its election and composition. Some stakeholders would like to see an CDM EB that is elected on the basis of merit and assessment of professional experience, rather than proximity to the negotiating process. The focus on negotiators as nominees inherently may bias the flavour of the CDM EB towards a more politicized body than it need or should be, according to some stakeholders. In addition, some stakeholders would like to see a full-time CDM EB, along with more active panels and working groups, in view of the perceived need to scale up the CDM.
16. Some stakeholders highlight the potential for conflicts of interest to arise and the need for a stricter code of conduct for CDM EB members.

*“If the CDM is to be scaled up over the coming years through increases in PoAs or NAMA related projects, or as other countries generate demand through their own trading schemes (Australia, Korea, China?), the dialogue might revisit calls for a more permanent and institutionalised role for the EB if the resources are available.” University of Sussex and University of East Anglia (submission no.11)*

*“CDM governance is under the control of the EB, which answers to the COP. However, it has been observed that the same EB members also represent their Parties on CDM issues at the COP. This may disturb the checks and balances that ought to be in place in CDM governance.” Jessica de Jimenez (submission no.15)*

*“One area that would need to be examined is whether a deeper separation between the oversight and regulatory aspects of the work would be beneficial, with clearer delineations between the CMP oversight process, and the regulatory process of the EB.” CEPS (submission no. 17)*

## **Conflict of interest issues with DOEs**

17. Designated Operational Entities are the entities accredited by the CDM EB to provide validation and verification services to project participants. The expectation is that, whilst under contractual relationship with project participants, DOEs will be able to provide independent, unbiased validation or verification opinions of high quality on the submissions by the project participants. This setup is similar to numerous other certification schemes, also in environmental or financial auditing, currently in operation.
18. However, as with financial auditing, claims exist that the system may lead to inherent conflicts of interest. Given that the business interest of the project participant relies on obtaining a positive validation or verification opinion, a DOE could feel under pressure from the project participant to facilitate such an opinion. Those who hold this view argue for a different method of DOE selection; one without the project participant involvement, for example, a system whereby the CDM EB selects the DOE for the project participant from a pool.

*“It may ultimately be the case that the EB has to have its own DOEs that project developers pay for that are more accountable to the EB than the project developer that pays them. This may help to address some of the issues of collusion among DOEs.” University of Sussex and University of East Anglia (submission no.11)*

*“We are concerned that a DOE may come under pressure with regard to providing impartial evaluations of submitted project activities when being contracted by a single project developer for a large part of its overall business turnover.” Climate Concept Foundation (submission no.12)*

*“Currently, the project proponents – usually the project developer – select and mandate the DOE that is to audit a CDM project. This practice can lead to significant proportions of the auditing work due for a project developer’s portfolio being commissioned to a very small number of DOEs.” International Rivers (submission no.22)*

## **2. Methodologies and Processes**

### **Background: The development of the CDM corpus of methodologies**

19. CDM methodologies provide the template for the assessment of additionality and for the establishment of the baseline scenario and the calculation of emission reductions in any CDM project. Project developers’ intent on using the CDM in a given context for which no methodology is available, will have to develop their own methodology proposal. Once provided by the project developer, the proposed methodology is assessed by the panels and working groups under the CDM EB, who work on it and then forward a product to the CDM EB for consideration. If the CDM EB approves the proposed methodology, it is then ready for use by the original project developer and any other project developer who is intent on developing a project that meets the applicability conditions set out in the methodology. The methodology effectively becomes “open source”.
20. Over the last 10 years, project developers have submitted more than 450 blueprints of methodologies, of which the CDM EB has approved approximately 200, including those methodologies developed top-down by the working groups of technical experts. Many of these methodologies have been revised and amended several times by the panels and working groups in the course of considering requests for revisions from the project participants.
21. In particular, the assessment of additionality and the calculation of baseline emissions have been highlighted in the submissions to the call for input as areas for improvement in the CDM.

### **Additionality assessment**

22. In most methodologies, the assessment of additionality is based on the use of an approved Additionality Tool (or in some cases, a so-called Combined Tool), developed by the CDM EB in the earlier days of the CDM. The tool prescribes essentially three tests to screen out all identified alternatives to project implementation:
  - The barrier analysis approach, in which project developers are required to identify non-financial/economic barriers (i.e. those that cannot be assessed with an investment analysis, such as technological barriers and lack of access to finance) that would prevent the implementation of the project without the CDM and to explain how the CDM will help to overcome such barriers;
  - The investment analysis approach, in which project developers are required to submit financial information that proves that the proposed project would not meet a required financial benchmark, or that the proposed project activity is not the

- most profitable among all the alternatives considered;
  - The common practice test, in which project developers are required to demonstrate that the proposed project is not widely observed in the relevant region. In case there are similar projects (other than those registered or applying for CDM registration), project developers are also asked to explain the “essential distinction” (usually policy-oriented such as preferential tariffs or government/ODA support) between these projects and the proposed project activity.
23. Each methodology will usually prescribe one or more of these tests in order to assess additionality. While the CDM EB and the CMP have repeatedly encouraged alternative formulations of additionality tests to be submitted for consideration, so far none have been received. The Additionality Tool or the Combined Tool remain the standard tools used in most methodologies for the assessment of additionality.
24. This approach carries a lot of criticism from several stakeholders:
- On the barriers approach, there is criticism that the identified barriers are not credible or could easily be circumvented through other actions than the project;
  - On the investment analysis approach, there is criticism of the use of specific, government-prescribed financial indicators for the use in CDM as these may not reflect actual conditions of the project but rather policy options by the government in order to attract CDM opportunities. Criticism is also directed at the lack of prescription of financial indicators and the use of inadequate benchmarks, which leads to the use of the most convenient financial indicator; and,
  - On the common practice test, some stakeholders regard it as a mere pro forma, given the lack of guidance thus far; it should be noted, however, that the CDM EB has recently developed fairly specific guidance on this.
25. Stakeholders critical of the current approach argue for a different type of additionality assessment. These alternatives fall mostly into four categories:
- *Performance benchmarks or market penetration rates*: additionality to be considered if a (normally quite high) performance benchmark or (normally quite low) market penetration is achieved – i.e. an activity to be considered additional if it ranks in the top x% of its group in performance, or if it has a very low penetration in the market, despite performing better in emission terms;
  - *Deemed savings or factors*: where a parameter is provided for in the methodology, which would normally be monitored. These may be, for example, average daily use of CFL in a household;
  - *Positive lists*: types of project activities which, by their characteristics, are deemed automatically additional. Typical examples include microscale project activities in renewable energy or energy efficiency; and
  - *Negative lists*: types of projects activities that are deemed automatically non-additional. Some stakeholders would include in such lists activities such as carbon capture and storage, large-scale hydropower or supercritical coal power plants (mostly on the basis of the argument that such projects are too large for carbon finance to have any impact on the additionality thereof).

*“Strong evidence suggests that as much as two-thirds of registered CDM projects could be non-additional.<sup>4</sup> Given that project-by-project additionality testing is inherently inaccurate, the CDM must be limited to those project types that are not being built on their own, and for which the CDM substantially increases the numbers of projects going forward.”  
International Rivers (submission no.22)*

*“A comprehensive ‘positive list’ that lists all the transition technologies should be created by each developing country taking into account its national circumstances, which can further enable such a transition. Any project that employs a technology from this list would be automatically deemed additional” Center for Science and Environment (submission no.31)*

## Baselines – from project by project to standardisation

26. Baseline determination is at the core of any offset standard. It requires the development of a counterfactual scenario – the baseline scenario, and its associated emissions, based usually on the perceived need for a given level of service (e.g. heat supply to an industrial process). The CDM Modalities and Procedures (paragraph 48) stipulate three possible approaches for the development of methodologies, including:
  - a. “Existing actual or historical emissions, as applicable, or
  - b. Emissions from a technology that represents an economically attractive course of action, taking into account barriers to investment, or
  - c. The average emissions of similar project activities undertaken in the previous five years, in similar social, economic, environmental and technological circumstances, and whose performance is among the top 20 per cent of their category.”
27. Despite the existence of the three approaches in the Marrakesh text, the majority of methodologies eventually adopted took the first or the second approach. The third – benchmark approach – has only recently been used with more frequency.
28. It can be said that the core of any CDM methodology is therefore the identification of all credible and realistic baseline alternatives; the screening out of those that would not be feasible; the identification of the most feasible/likely alternative scenario; and the calculation, using conservative parameters, of the associated emissions.
29. As many of the processes in project activities, in particular for larger scale projects, are quite complex, the identification of alternatives may require extensive data collection and mining. It also requires extensive analysis of the proposed algorithms, in order to identify any possible avenue for inflation of the baseline, i.e. a baseline calculation leading to higher emissions than would be reasonable to expect in that particular scenario, therefore leading to additional claims of emission reductions from the ensuing project.
30. This analysis, undertaken by the Meth Panel on a methodology-by-methodology basis, results in fairly complex templates and algorithms, sometimes running into more than 100 pages of very detailed prescriptions in relation to the project. In turn, this generates very high costs to the development of any methodology. Together with the open source nature of the final product, this leads to a general discouragement of private sector development of methodologies, with the exception of those methodologies deemed highly profitable. Indeed several methodologies with lower emission reduction potential have been developed with some involvement of development agencies or banks.



31. This has led many stakeholders to question the wisdom of the current setup, and alternatives have been proposed. Generically, these revolve around variations on the concept already set out in paragraph 48(c) of the CDM Modalities and Procedures – that of standardized baselines.
32. Standardized baselines were discussed throughout several negotiating rounds of the CMP. In Cancun, the CMP requested the CDM EB to develop top-down standardized baselines for use in least developed countries, in particular, and in priority sectors, while simultaneously allowing for independent submissions by Parties or other stakeholders of proposals for standardized baselines. During 2011, the CDM EB developed the framework for consideration of such proposals.
33. Much of the input received in the submissions relating to standardized baselines calls for an acceleration of the deployment of standardized baselines, whilst alerting to the potential dangers to the environmental integrity of the mechanism stemming from ill-defined and not-so-conservative standardized baselines. Concern was expressed by some stakeholders regarding the approach taken by the CDM EB in the development of standardized baselines.

*“Standardization with the sole purpose of bringing transaction costs down is likely to lead to an imbalanced outcome. (...) A race to the bottom due to host country competition in standardization has to be avoided.” Perspectives (submission no.23)*

#### **Sectoral coverage of existing methodologies – an untapped potential**

34. Several stakeholders note that the existing coverage of methodologies is not necessarily extended to sectors and areas of activity with the highest potential, or those which contribute most to transformational change, but rather those where investors found opportunities for cost-effective emission reductions. According to these stakeholders, areas with high sustainable development benefits, such as transport, housing or agriculture have, in practice, been left out of the CDM.

*“The need for investment in climate change mitigation in the transportation sector is especially urgent, but due to several barriers in the CDM institution, it is significantly under-invested in the sector relative to its share of global GHG emissions.” Cornie Huizenga (submission no.19)*

*“I would like to propose that the Committee explore the possibilities of expanding the CDM framework to include design, resource extraction and processing for product manufacture, use and end of life issues. To do so would take the benefits of the CDM directly into the lives of billions of people on the planet that aspires to consume a vast array of products.” Carbon Redress (submission no. 26)*

*“CDM represents an excellent mechanism to enable global stakeholders to utilize and benefit from bamboo’s potentials in climate change mitigation.” INBAR (submission no.27)*

#### **Perverse incentives generated by the CDM – the issue of E+/E- policies**

35. Concerns have been expressed in relation to a set of perverse incentives that the CDM may be putting in place.
36. In the early days of the CDM, there were calls for the consideration of the potential “freezing” effect that the mere existence of CDM might have on the development of environmental policy. In brief, the argument put forward was that, given that the CDM rewards those situations with higher emissions in the baseline, it could potentially lead countries to avoid putting in place strong environmental policies that could potentially

result in disqualifying them from access to the CDM. To address this argument, the CDM EB provided guidance early on stating that:

(a) Only national policies that give comparative advantages to more emissions-intensive technologies or fuels over less emissions-intensive technologies or fuels (so-called **E+ policies**) that have been implemented before adoption of the Kyoto Protocol by the COP (11 December 1997) shall be taken into account when developing a baseline scenario

(b) National policies or regulations that give comparative advantages to less emissions-intensive technologies over more emissions-intensive technologies (e.g. public subsidies to promote the diffusion of renewable energy or to finance energy efficiency programs) that have been implemented since the adoption by the COP of the CDM M&P ( 11 November 2001) (**so-called E- policies**) need not be taken into account in developing a baseline scenario (i.e. the baseline scenario should refer to a hypothetical situation without the national and/or sectoral policies or regulations being in place).

37. This dual treatment of existing policies allowed for the alignment of the CDM incentive with the policy incentive – countries could henceforward promote renewables, as an example, through setting up feed-in tariffs, without fear of hurting themselves competitively. The feed-in tariff would be deemed an E- policy and could therefore be disregarded in the development of the baseline. By contrast, those E+ policies (e.g. subsidies to coal use in power plants) that had been in effect since 1997 and that remained in place at the time of the development of the project activity must be taken into account in the baseline.
38. The application of the E+/E- rule is seen by some stakeholders to have provided, in fact, a different set of problems. When applied uniformly across a whole sector in fast development, it has led the CDM to disregard the evolution of environmental and energy policy in non-Annex I countries, and may over time lead to ever more inconceivable counterfactuals, for example, the ongoing disregard in the baseline of highly effective feed-in tariffs. The High-Level Panel has been urged in some submissions to consider the issue of E+/E- and the applicability of current regulations.

*“The dialogue should also look at measures which ensure the continued and improved environmental integrity, additionality, efficiency, and contribution to sustainable development of the CDM, through improvements of the modalities and procedures, including through: [...]”*

*11.2. Measures to ensure baselines reflect changes in conditions: The dialogue may also want to consider technical concepts such as; ways to address the inclusion of existing CDM projects in project baselines and additionality assessment of new projects, and ways to strengthen baselines for new projects over time reflecting autonomous technological improvements without discouraging such future developments.*

*11.3. Measures to address perverse incentives and other subsidy effects: The policy dialogue may also look at ways to avoid a discouragement of domestic climate mitigation policies of host countries in order to maintain revenue streams from CDM certain project categories. A critical assessment of the current E+/E- guidance may be illustrative in this context.” European Union (submission no. 54)*

*“Suggested areas for consideration are: [...]”*

- Assess the current application of the E+/E- rule*
- Look into the different interpretation and evolution of the E+/E- rule” CMA (submission no.42)*

### **Perverse incentives generated by the CDM – the case of HFC-23 and “clean coal”**

39. Some stakeholders are particularly concerned by perverse incentives of a different nature, attributable in their views to specific project types.
40. *HFC-23 destruction projects* feature significantly in the current levels of overall issuance of CERs. HFC-23 is a by-product of the chemical manufacturing process of



HCFC-22, a gas commonly used in refrigerant applications. Given the very high global warming potential of this gas (11,700 times more powerful than CO<sub>2</sub>), these industrial projects were among the first projects to be proposed, and such projects routinely yield very high quantities of CERs. There have been claims, in the submissions to the Policy Dialogue, that these projects create perverse incentives for the maintenance of production of HCFC-22, despite an internationally-agreed phase-out schedule for HCFC-22 (it being an ozone depleting substance under the Montreal Protocol). Recently, post-2012 CERs from these project types have been excluded from the European Union Emission Trading System. Some stakeholders would like to see the High-Level Panel investigate further the impact of these projects.

41. *High efficiency coal-fired power plants* have also been the subject of controversy and scrutiny by stakeholders. This results from a point of principle with some, i.e. that the UNFCCC and the CDM should not be financing fossil fuel based solutions. An additional complaint mentioned relates to the financial additionality of these projects, which some stakeholders claim is questionable.
42. An opposing view held by some and also present in the submissions holds that the CDM should be as technology-neutral as possible, given the diversity of solutions required to fight climate change.

#### Scaling up efforts

43. Many stakeholders assert that the CDM as an instrument has not shown itself to be readily scalable and able to assist significantly in the mitigation challenge that the UNFCCC is asked to tackle:
  - The CDM project-by-project approach is deemed to be too burdensome and too unwieldy for some promising areas of emission reduction. In particular, where network or scale effects are present, the current project-by-project approach fails to recognize and reward such effects, by mandating in many cases too many checks on emission reductions. Despite methodological developments such as the introduction of “deemed savings” factors or default parameters, the overall approach taken in project-by-project validation and verification explains the relatively low use of CDM in sectors such as transport and housing, which rely in many cases on indirect network effects or very small emission reductions at the single unit (e.g. household, or bus) level. Despite the promise of “programmatic CDM”, the CDM has not made significant inroads in these sectors;
  - While project-by-project approaches have been deemed too burdensome, it has been difficult (to date) to use the existing CDM infrastructure to fashion sector-wide emission reduction programmes. Such sectoral approaches, deemed to have a larger reduction potential than the current approach have, to date, presented several coordination issues. In many cases, making sure that the agent in such CDM programmes is awarded the right incentive to take action (e.g. the tenant who is given a light bulb or an efficient appliance in a CFL/appliance distribution CDM programme) requires an extensive infrastructure and organization;
  - Given the need for larger, more ambitious efforts to reduce emissions, an increase in scale of emission reductions under the CDM should likely go hand-in-hand with either more ambitious targets for developed countries or a measure of discounting.

## Process improvements

44. In the last few years, the CDM EB has undertaken a reform of its documentation and a review of the main procedures (registration, issuance, methodology development) with a view to increasing its overall performance. This reform has resulted in a consolidation of existing guidance (for example, as of December 2011, three main documents now contain the near totality of requirements for project participants and DOEs in relation to validation, verification and operation of CDM projects), streamlining of requirements, and an increase in the level of interaction with stakeholders.
45. Whilst some stakeholders note that there has been an improvement of performance of the CDM EB and the secretariat in managing the pipeline of submissions, there have been requests for further streamlining processes. Some of that streamlining is inherent already in the push for a more standardized assessment of additionality and the use of standardized baselines in methodologies.
46. Some stakeholders are requesting that the more routine steps in validation and verification be moved onto electronic platforms and digitized, in order to free up resources and increase the level of quality of scrutiny of projects by the secretariat and DOEs. They suggest that the High-Level Panel conduct consultations aimed at finding opportunities to increase the overall efficiency of the system and streamline and automate processes, where feasible.

*“The CDM’s project-based approach in which it assesses the additionality and eligibility of each project on a “ton-by-ton” basis is very time- and resource-intensive, inefficient, and does not seem capable of effectively being applied to a large number of projects to generate a large supply of offset credits.” EPRI (submission no.6)*

*“The EB continuously has expressed concerns regarding the quality of DOEs’ work, and these concerns have been reflected in the increase in requests for review at registration, and in suspensions of leading DOEs” EPRI (submission no.6)*

*“The efficiency and timeliness of the CDM process has been identified as a key barrier to participation and further growth of the CDM. We understand that there has been work to address issues raised by stakeholders regarding the efficiency of processes including the restructure of the Secretariat. While this work is ongoing BCA/AIGN recommend that the Policy dialogue consider the barriers to efficiency” AIGN – Business Council Australia (submission no. 18)*

### 3. Sustainable development

47. An enduring discussion under the CDM is its contribution to sustainable development. Under the CDM, there is no agreed definition of sustainable development, despite forming part of the two-fold purpose of the CDM, as stated in Article 12, paragraph 2 of the Kyoto Protocol.
48. The CDM modalities and procedures further define that it is the prerogative of the host country, through its written approval, to certify that the proposed project activity “assists it in achieving sustainable development”. This requirement places squarely on the host country and its DNA the responsibility for the definition and assessment of the contribution to sustainable development.
49. Nevertheless, many stakeholders emphasize the lack of a definition of sustainable development in the context of the CDM, which may lead, in a competitive environment, to a lowering of standards.
50. Moreover, the lack of capacity of DNAs and the pressure that they may face leads some stakeholders to believe they are not necessarily well placed to guarantee that

sustainable development benefits will materialize, even though they are sanctioned by the DNA in its letter of approval.

51. Thus, some stakeholders urge the High-Level Panel to conduct an in-depth assessment of the role and practice of the CDM EB and DNAs in relation to sustainable development, for example by assessing the use of sustainable development indicators in DNA project assessments. In addition, the introduction of a “do no harm” assessment in order to avoid negative impacts on the local environment has also been proposed. Another proposal is that the CDM should adopt international best practice and standards for environmental protection, public participation and indigenous rights. Ways to involve local stakeholder groups in the project should also be investigated by the High-Level Panel, according to some stakeholders.

*“Our own work confirms findings of existing studies, however, that point to a systematic neglect of the SD contribution of CDM projects. This results from a lack of financial incentives, weak DNA capacity to check up on SD contributions and the absence (other than perhaps with Gold standard projects) of verification of whether SD benefits claimed in PDDs have really been achieved.” University of Sussex and University of East Anglia (submission no.11)*

*“The EB has an important role in promoting best practices, particularly through its guidance through the validation and verification standard (VVS). This would not involve dictating SD criteria to the NCDMA, but rather looking for evidence that a proper screening of SD benefits has taken place. In this respect the High-Level Panel may consider a potential role for civil society organisations in screening PDDs for SD benefits.” University of Sussex and University of East Anglia (submission no.11)*

*“The Board should require that all projects meet international best practices and standards for environmental protection, public participation and indigenous rights before host and buyer countries issue approvals for these projects to participate in the CDM.” International Rivers (submission no 22)*

*“The sustainable development contribution of projects could be enhanced by an increased focus by buyers, particularly governments, on highly beneficial projects. Moreover, monitoring reports should include statements about sustainable development benefits if such benefits have been invoked in the PDD. These statements would have to be verified by the DOE.” Perspectives (submission no.23)*

### Stakeholders: an appropriate definition

52. The CDM Modalities and Procedures define stakeholders as “the public, including individuals, groups or communities affected or likely to be affected, by the proposed CDM project activity”.
53. However, applying this definition in practice has been somewhat difficult. In particular, diverging interpretations of the meaning of “affected” make it difficult to reach consensus on who should be consulted. This is compounded by a lack of guidance from the CDM EB on the matter. This lack of guidance is explained by a reliance on national regulations related to stakeholder engagement in processes such as the environmental impact assessment. The CDM EB has been reluctant to be very prescriptive in specifying particular requirements to be met by national agencies, both for fear of encroaching on or conflicting with national responsibilities, and for fear of lowering standards in host countries with already good consultation procedures.

*“Stakeholders should be clearly defined by the EB in order to achieve full participation. We believe that the following groups are to be included as stakeholders: 1) local populations potentially affected by the project activity, 2) local authorities, 3) at least 1 person from the DNA, 4) relevant local NGOs working on the issue and 5) at least 1 person from the DOE undertaking the validation of the project to ensure objectivity. All defined stakeholders must be invited for local stakeholder meetings. Follow - up meetings should serve to clarify how potential problems will be mitigated and addressed. Such meetings shall take place before the project is submitted to the UNFCCC for validation and 30 - day global commenting period.” Paryavaran Mitra (submission no.8)*

## Public participation in the CDM project cycle

54. In the CDM project cycle, there are two separate processes for stakeholder participation:
- *A process of consultation with local stakeholders*, usually conducted in the region or country hosting the project. The CDM Modalities and Procedures do not stipulate how, where and when this consultation is to take place. The process is meant to be conducted by the project developers in the course of their project development and should be documented along with the project submission. However, DOEs are meant to ensure that “comments from stakeholders have been received and taken into account”;
  - *A global stakeholder process*, regulated by the CDM Modalities and Procedures, under which project design documents are to be displayed on the UNFCCC website for a period of 30 days (45 days for afforestation and reforestation projects). The DOE is to consider comments made by stakeholders and report on them in the validation process. The CDM EB further instructed that this should be the first formal step of the validation process.
55. Civil society organizations have repeatedly expressed , and also in response to the call for inputs, several inadequacies with the current system of public participation by stakeholders, including:
- Local stakeholder consultations are managed by the project developer, giving rise to a potential conflict of interest and bias towards favourable stakeholders;
  - Claims that current procedures are routinely disregarded by DOEs and project participants;
  - All documentation is made available in English. This may be wholly inadequate in regions where literacy levels, let alone proficiency in a foreign language, are very low;
  - The lack of guidance on minimum standards of diligence in relation to procuring stakeholder comments and the short time available for comments mean that most opportunities for public comment are not used;
  - There is no process to receive comments from the public and from directly affected stakeholders after the initial stage of validation, when the project is actually operating.

*“A very important way this information can be made available to stakeholders and persons worldwide is to have them in a language they can understand.” Asociación Ambientalista de Chiquiri (submission no.7)*

*“There are even affected stakeholders which in fact do not even speak the national language, much less English.” Asociación Ambientalista de Chiquiri (submission no.7)*

*“(…)after the local consultation process has ended the EB should create clear guidelines on how to assess comments by the DOE. Comments and names of participants should be disclosed such that their particular concerns and their assessments are transparent.” Paryavarán Mitra (submission no.10)*

*“The secretariat needs to improve its communication system and submit clear deadlines and step-by-step indications on how to submit comments”. Paryavarán Mitra (submission no.10)*

*“One last suggestion is to keep the channels open and not limit the comment period to only one month, but rather to **KEEP IT OPEN** for the period of validation, in any event any period with a minimum of **3 MONTHS**”. Asociación Ambientalista de Chiquiri (submission no.7)*

*“Stakeholders that commented on CDM projects published for global stakeholder consultation should receive a statement on how their comment has been taken into account.” Climate Concept Foundation (submission no.12)*

*“Awareness regarding the CDM public consultation is very low. Affected people don’t know about the right and importance of the public consultation. There is no transparency regarding public consultation. The Designated National Authority should hold capacity building mechanism such as training and workshop to create a pool of organisations who would act as an expert in holding these meeting and ensure public participations in stakeholders meetings.” Gujarat Forum on CDM (submission no.20)*

Several proposals have been made in relation to improvements to the public participation stage, such as:

- Modalities and procedures to establish means for stakeholder involvement during the implementation of a CDM project activity;
- Modalities and procedures to improve stakeholder involvement at local and global levels incorporating, inter alia, provisions for:
  - o Guidelines for project developers on how to announce and conduct local stakeholder consultations;
  - o Guidelines for DOEs on how to validate local stakeholder consultations;
  - o Improved automated notification systems for all public participation procedures that are time-sensitive.
- Participation of civil society representatives at all stakeholder meetings including at meetings of the DNA Forum.

### **Women’s rights, indigenous peoples’ rights and human rights**

56. The CDM EB also repeatedly receives input, and input has been received in this particular call, highlighting deficiencies in the current system of public participation in the CDM, notably in relation to specific groups:

- Women are seen to have a large role in the promotion of sustainable livelihoods, yet no specific role is assigned to them in the CDM. There have been suggestions that the role of women should be further strengthened, by providing an assessment of the impact of CDM projects on women’s livelihoods, and assessing the contribution that women and women’s groups can make to further improve the sustainability of CDM projects. One particular group highlights the fact that despite repeated encouragements to regional constituencies to enhance the gender balance of the CDM EB, it remains predominantly male.
- Indigenous peoples’ rights have been routinely affected by the development of CDM projects, it is claimed, without due diligence in procuring their consultation.

57. Stakeholders have also raised the issue of human rights. In recent cases, the CDM EB was confronted with allegations of human rights violations as a result of proposed CDM project developments. The CDM EB has responded by stating that it does not have the mandate to conduct investigations on human rights abuses, and that it should concern itself only with proper compliance with the CDM requirements, including those on stakeholder consultation. Several of the inputs claim that this may be too narrow an interpretation of its own mandate, and that the issue might be covered by the CDM EB's responsibilities vis-à-vis the Charter of the United Nations. This issue is deemed by some stakeholders to be an issue that should be further investigated by the High-Level Panel.

*"CDM projects that violate human rights should not be eligible for registration, and currently registered projects that violate human rights should be suspended." International Rivers (submission no.22)*

#### 4. Trade and Finance Issues

##### The impact of CDM in leveraging finance for the transformation to the low-carbon economy

58. Some stakeholders believe that the level of transaction costs involved in the development of CDM projects to date has severely stunted the possibilities for truly transformational levels of finance. The risk-reward balance is in this view considered simply not adequate or fit for purpose.
59. Unfortunately, the CDM project cycle documentation does not have the requisite data to allow any inference in relation to the levels of investment generated. Some stakeholders would like to see the High-Level Panel investigate past and projected levels of finance potentially generated by the CDM in its current form and in its newer forms (using programmatic approaches and standardized baselines), while at the same time looking into ways of maximizing any potential leveraging impact the CDM may contribute to the deployment of climate finance. This implies also, as stated by some stakeholders, looking in particular at the relationship between private flows of finance through the CDM, and public flows of finance through either multilateral instruments such as the Green Climate Fund or bilateral climate finance.

*"the CDM also faces increasing competition from alternative mitigation funding mechanisms, such as fast start finance (FSF) and, in the longer-term, \$100 bn of 'public and private' funding to be provided annually by 2020." Nexus (submission no.21)*

*"In 2011 Nexus conducted a study on carbon finance transactions costs for household energy projects. The principle findings of the study were that the highest costs were human resources and DOE costs, and that household energy projects, which accumulate scale over time, are likely to be loss making in the first two to three years. In order to participate in the CDM, organizations running these projects need access to appropriate financing instruments such as pre-finance or debt. (...) development practitioners are typically unable to take on these liabilities" Nexus (submission no.21)*

*"It is becoming more and more evident that diverse climate finance opportunities are being sought and is being targeted by nations though much of it with no clarity. In the effort to diffuse such confusion, the CDM should use this opportunity to reflect its comparative attractiveness and at the same time put a frame work to check the possibility of double counting climate finance for the same effort." Dialo Umkele (submission no.29)*

*"If the CDM cannot do so more effectively than other policies and mechanisms, then the vast resources engaged by the CDM should be deployed elsewhere. Mitigation is increasingly urgent, and we need to be asking ourselves resource optimization questions, for example: If the billions invested in CDM had instead been invested in assisting developing countries with implementing key NAMAs, such as reforming utility regulation, tariff design and incentives, or establishing robust regimes for mandatory minimum energy performance requirements and building codes, could a better outcome for the climate system have been achieved?" Policy Solutions (submission no.32)*



## Links to financing models in developing countries

60. The CDM provides finance to project developers in the form of an expected income stream coming from the issuance and transfer of certified emission reductions – an asset class that can be sold in the market. Financial markets have developed instruments based on this asset class, such as forward and/or options transactions based on delivery of CERs from projects in years to come, or “swaps” with other carbon asset classes for use in the European Union Emissions Trading System. In supporting this financial innovation, a variety of information services, rating agencies, and risk models have been developed.
61. The use of these various financial instruments contends, however, with the very basic fact that project implementation requires, in most instances, the deployment of immediate financial resources in return for what may be an erratic, volatile and uncertain carbon revenue stream sometime in the future. In turn, this requires either a strong reliance on upfront equity by project developers (something not usually available, especially to smaller developers), or the construction of financial instruments that equate risks and rewards in a more favourable manner. Several instruments have been proposed, even outside of the CDM sphere, to deal with a number of carbon-specific financing risks (such as “green bonds”). Yet the use of such instruments is still limited, and their applicability in the CDM context is not known. What is known is that carbon finance is still in its infancy in many CDM constituencies and that a possible fruitful investigation into financing models in operation in the CDM might bring out lessons learned and pitfalls to avoid. The High-Level Panel has been asked to investigate the financing of CDM projects and the potential use of different financial instruments.

*“The Panel should consider establishing a working group (...) Some of the areas that this working group should consider are:*

- Understanding how CDM projects get financed*
- Understanding the CDM as a financing mechanisms for emissions reductions*
- Exploring strengths and weaknesses of the mechanism in attracting risk capital*
- Aspects of the CDM that help mitigate the risk of investing in emerging markets*
- The nature of Certified Emission Reductions (CERs) that has allowed the use of CERs as ‘AAA collateral’*
- Exploring the role of the CDMs financing model as payment for verified results in the context of broader climate finance instruments” Carbon Markets and Investment Association (submission no.42)*

## Competitiveness issues and carbon leakage in the CDM

62. Given that the CDM finances emission reduction in developing countries from developed countries’ efforts to meet their mitigation targets, it has the potential to exacerbate competitive distortions, according to some stakeholders. It may also contribute to the potential leakage of carbon emissions across the developed/developing divide. Such carbon leakage reflects the fact that companies exposed to carbon constraints in Annex I (for example, in the European Union carbon market) may choose to relocate or increase their emissions outside Annex I. By subsidizing emission reductions outside Annex I in sectors in competition with Annex I companies, this effect may be reinforced by the CDM. The net effect of the CDM could eventually even be negative. The High-Level Panel is asked by some stakeholders to investigate such carbon leakage and its extent, if any.

*“In considering options for more comprehensive approaches that focus on specific sectors, it is important to recognize that firms in sectors compete with one another at the national, regional and global levels. As such, they must be designed to complement and work with existing competition laws and must not provide competitive advantages that encourage carbon leakage” Business Europe (submission no.34)*

## 5. Architecture of the CDM: what next for the CDM?

### Two alternative views on the setting of the CDM: the CDM as an integral part of the Kyoto Protocol or as an instrument beyond Kyoto

63. In the view of some stakeholders, the CDM is an integral part of the Kyoto Protocol and has been conceived as an instrument to pursue the twin objectives of sustainable development in host countries and cost-effective mitigation opportunities in compliance with emission reduction targets by developed countries under the Kyoto Protocol. One view propounded by several stakeholders, therefore, is that the future of the CDM is tied to the future of mitigation efforts under the Kyoto Protocol. Some stakeholders therefore emphasize the need for adequate signals from Annex I Parties in relation to continuing future demand for the CDM, which could be obtained by early ratification of a second commitment period, coupled with ambitious reduction targets.
64. Some stakeholders, however, look to a future CDM which may encompass other roles. While not denying the initial role of the CDM as a tool in the compliance toolkit of Annex I Parties with targets under the Kyoto Protocol, they emphasize possible roles of the CDM beyond compliance with Kyoto.

*“The effectiveness of carbon markets would be negatively affected by continued fragmentation of chosen climate change policy approaches. We would therefore like to encourage a closer cooperation with key carbon market regulatory bodies like the European Commission.” Climate Concept Foundation (submission no.12)*

*“The CDM is regulated at the international level through the CDM EB, which is constituted by the CMP. (...) At the same time, national and regional regulators, which determine “demand requirements” also have an important role to play. One of the main issues observed has been the lack of coordination between the two regulatory levels” CEPS (submission no.17)*

*“If the CDM continues in its current format, it is likely that it will become a process of managed decline. Markets for CERs are not materializing, buyers are reacting against pure offset projects, host countries are considering their own domestic schemes which may internalise offset opportunities and inevitably lead to the development of their own E+/E- policies as part of their own domestic efforts, and new mechanisms are under formation.” Project Developer Forum (submission no. 14)*

*“Nexus would support the view that parties need to send a strong signal regarding the future of the CDM. Existing signals indicate that the CDM will be positioned away from ‘industrial’ projects in economies in transition<sup>2</sup> and maintained in LDCs.” Nexus (submission no.21)*

### Emphasis on the imbalance of supply and demand

65. While these broader views of the potential role of the CDM are expressed by some stakeholders, there is widespread recognition in the submitted material of the lack of balance between supply and demand in the current market for CDM. The situation of the market for CERs is a difficult one: on the supply side, improvements at EB and DOE level have led to an increase in the rate of issuance of CERs; on the demand side, the current European crisis has led to a collapse of demand. Prices in the market have fallen from €8-9 to €3-4 in the past year. Some stakeholders are urging measures such as price controls (e.g. a “price floor”) to manage the volatility in prices. This current market situation, together with recent decisions taken in the demand markets, leads some to ask for more coordination and dialogue between regulators, i.e. between the CDM EB and those entities in charge of regulating demand markets (e.g. the European Commission for the European Union Emissions Trading System).



*“CDM must include a minimum floor price, which will ensure that only high end or transition technologies will get into the system in order to ensure the real transition to a low-carbon economy” Center for Science and Environment (submission no. 31)*

### Views against CDM, emission trading and the commodification of nature

66. It is argued by some stakeholders that the current level of prices in the global carbon markets will do little in terms of spurring the long-term behavioural and technological change required to meet the target of long-term stabilization at a maximum of 2°C above pre-industrial levels.
67. This market collapse, together with various controversies around the operation of both the CDM and the European Union Emission Trading System (claims of non-additionality, fraud or misstatements in validation and verification, human rights abuses, VAT fraud and phishing (in the EU ETS)) lead some stakeholders to ask for a wholesale rethink of the approach of funding through carbon markets. These views also rely on claims of vindication from the recent controversies around the global financial system and the causes of its crises. For these stakeholders, the use of carbon markets and market-based approaches to solve issues of global public goods such as the atmosphere is a misguided pursuit and reliance on these approaches should be terminated, while other, more traditional, public finance sources should be used instead.
68. A moral argument against the commodification of nature is also present in some stakeholders' views. In this group's views, emission trading and associated instruments such as offsets fail on moral grounds by attempting to monetize public goods such as the atmosphere, resulting in a “privatization” of a public good. Moreover, in this same group's view, the use of emission trading and offsets is seen as simply yet another use of the same ideology that led the world into the financial crisis.

*“The critique can be summed up in several points:*

- *the idea of inventing a property right to pollute is effectively the ‘privatization of the air’, a moral problem given the vast and growing differentials in wealth inequalities;*
- *the corporations most guilty of pollution and the World Bank – which is most responsible for fossil fuel financing – are the driving forces behind the market, and can be expected to engage in systemic corruption to attract money into the market even if this prevents genuine emissions reductions; (...)*
- *the idea of market solutions to market failure (‘externalities’) is an ideology that rarely makes sense, and especially not following the world’s worst-ever financial market failure, and especially not when the very idea of derivatives – a financial asset whose underlying value is several degrees removed and also subject to extreme variability – was thrown into question. ” University of KwaZulu-Natal (submission no.58)*

### CDM in the future international climate change regime: interplay with NAMAs

69. The recent decisions in Durban have launched the Ad Hoc Working Group on the Durban Platform, with a view to completing by 2015 its work on “a protocol, another legal instrument or an agreed outcome with legal force under the Convention applicable to all Parties”. At the same time, existing decisions from Copenhagen and Cancún have established a process whereby Parties are to inscribe in a registry their “nationally appropriate mitigation actions” (NAMAs) which non-Annex I Parties undertake to accomplish, subject to appropriate resource and financial support.
70. In addition, at Durban Parties *defined* “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, [...] and which, subject to conditions to be elaborated, may assist developed countries to meet part of their mitigation targets or commitments under the Convention”.

71. These two separate processes will impact on the CDM in the future. As no clear picture exists of the modes of financing for the nationally appropriate mitigation actions being put forward at this stage, there remains an open question with regard to the role of the CDM vis-à-vis these NAMAs. Moreover, the development of a new market-based mechanism under the Convention, together with a work programme to consider a framework for various new (nationally-based) approaches, including market-based approaches (e.g. emission trading systems or carbon offset systems) leads to the possibility of several competing instruments: the CDM, direct finance for NAMAs, a new market-based mechanism to finance at a more aggregate level than “traditional CDM” and an emerging, more loose, definition of a framework for national emission trading and offset systems. The High-Level Panel is therefore asked to investigate the possible interplay of the CDM with NAMAs and new-market based mechanisms.

### CDM and the interplay with national initiatives

72. As with international policy developments, recent national policy developments also challenge the future role of the CDM. Regional carbon markets which currently provide the main source of demand (e.g. the European Union Emissions Trading System) are increasing in number and scope, and are being developed in both industrialized and developing countries. Capacity-building initiatives are being set up to assist in the development of the new markets and mechanisms.
73. Several stakeholders would therefore like to see a particular focus of the Policy Dialogue on the role of the CDM in relation to the wider context, both of the negotiations on carbon markets, and also of the very real development of national initiatives on carbon markets in several Annex I and non-Annex I Parties.

*“Over seventy countries are in the process of voluntarily developing Low Carbon Development Strategies. Taking priorities identified under these as a basis for generating relevant methodologies, identifying potential investors, or as a basis for promoting sustainable development priorities might help CDM finance add value and multiply benefits.” University of Sussex and University of East Anglia (submission no.11)*

*“We suggest that the high-level policy dialogue also include a discussion on the role and potential contributions of the CDM in the climate policy at the international (UNFCCC) level, as well as the regional and national levels.(---) Possibilities and implications of scaling up the current CDM project-based approach to sectoral and/or policy-based crediting (i.e. beyond current eligible activities under projects and programmes of activities)” (---) Role of the CDM operating alongside a potential new carbon crediting mechanism”. World Bank (submission no.16)*

*“It is now becoming clear that many of the “users” of CERs only see CDM as being legitimate in certain jurisdictions and/or sectors of the economy. Should we simply ignore that at the level of the UNFCCC regulation, or should this reality be recognized and attempt be made at harmonization? What role should the CDM play, and under what circumstances?” CEPS (submission no.17)*

*“The CDM has a critical role to play in the market and, irrespective of future agreements under the UNFCCC, that role must continue. It is our view that the institution should establish itself as the single agency delivering international abatement units under all current and future mechanisms agreed within the UNFCCC (CDM, REDD+, NAMA’s etc).” AIGN – Business Council Australia (submission no. 18)*

*“Bankability of CERs into the new agreement to be negotiated under the Durban Platform should be ensured. Lessons learnt from the CDM such as sufficient incentives for the private sector and absence of ad-hoc government intervention should inform the design of the (a) New Market Mechanism(s) (NMM).” Perspectives (submission no.23)*

## Going beyond offsetting

74. Some stakeholders note that the objective of moving to vastly decreased global carbon emissions must eventually mean that reliance in pure emission offsetting instruments, where one tonne credited leads to one tonne being emitted elsewhere, must stop. Offsets are therefore seen as a transitional instrument towards a world with vastly reduced emission budgets requiring emission reduction efforts globally.
75. In its current role envisaged under Article 12 of the Kyoto Protocol, the CDM remains an offsetting tool. However, some observers would rather see it evolve into a mixed instrument, in that not all of the emission reduction obtained would result in a tradable offset. This can be done in various ways, but mostly through some sort of discounting or by the use of crediting baselines that are lower than business-as-usual conditions.

*"It is widely recognised by parties on all sides of debates over the CDM that assessment of additionality involves subjective judgment over baselines and cannot achieve 100 per cent accuracy. Discounting CERs creates the possibility for the CDM to produce a net climate benefit, rather than a zero sum game" University of Sussex and University of East Anglia (submission no.11)*

*NAMAs and crediting baselines create opportunities for host countries to set internal targets for selected sectors, thereby ensuring that projects contain an element of "own contribution" and move away from pure offsetting where all the emission reductions are used to offset emissions in Annex 1 countries, to a situation where only a portion are used. Such an objective can be met in several different ways, including for example the bottom-up establishment of crediting baselines or top down discounting of CERs." Project Developer Forum (submission no.14)*

### **III. Suggestions from stakeholders in relation to the consultation process**

76. In addition to suggestions on the scope and content of issues to be tackled in the CDM Policy Dialogue, suggestions were made on the consultation process going forward.
77. Some stakeholders proposed in particular that the work of the High-Level Panel be structured along a particular axis:
  - A first step/chapter in the High-Level Panel's work would be to conduct an assessment of the performance of the CDM in relation to its stated objectives. Suggestions were made in some submissions as to the type of indicators that could best mirror current performance;
  - A second section would then discuss the experience so far of the mechanism, its shortcomings and challenges;
  - Finally, the High-Level Panel is urged to focus on the future role of the CDM.
78. The High-Level Panel was also urged by some stakeholders to be transparent in its proceedings:
  - Ensure a balanced representation of interest among different groups;
  - Keep public records of all engagements and communication with public or stakeholders;
  - Make meetings open to observers and make meeting documentation readily available to all stakeholders;
  - Make the report public, without modification.
79. There were concerns raised by some stakeholders over the current make-up of the High-Level Panel, in that it did not, for example, contain any representative of local communities. It was therefore strongly suggested that this perceived shortcoming be made up for by strong consultation processes, especially with those groups "not represented" on the High-Level Panel.

80. It was suggested in one submission that the High-Level Panel decide at an early stage on the range of topics to be covered and issue a new, more targeted call for submissions on such issues.

The same submission suggested that the High-Level Panel undertake consultations in several regions, so as to facilitate in particular regional participation in the Policy Dialogue.