

Reformed CDM and Transition to New Market Mechanisms

2012

Survey Highlights:

- General agreement on need to simplify the currently complex CDM operational procedures.
- Divided opinion on whether the new regulatory framework and standardized baselines will help reduce the complexities and lower transaction costs.
- High expectation that adoption of standardized criteria for sustainable development by host country DNAs will boost sustainable development in their respective regions.
- NAMA Crediting is among most preferred options for New Market Mechanisms.
- Divided opinion on whether to gradually replace CDM with New Market Mechanisms or operate the two schemes in parallel.
- High hopes that credit price will increase though it will vary under different mechanisms if all international schemes are operated in parallel.

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Introduction

With the end of the first Kyoto Protocol (KP) commitment period on 31 December 2012, many questions have been raised about the future of the Clean Development Mechanism (CDM). The agreement of a second commitment period to the KP will provide some certainty that flexible mechanisms under KP such as CDM will be supported beyond 2012. While the Kyoto flexible mechanisms have played an important role to begin mobilising technology and capital into developing countries, it is likely that over time new financial mechanisms will be developed to accelerate the flow of capital needed in developing countries. This was made clear in Durban where it was agreed that work has to be completed no later than 2015 to adopt a new instrument at the 2015 UN Climate Conference which would replace the KP and be implemented from 2020.

On the other hand, U.N. Climate Change Conference in Cancun, Mexico approved a set of decisions anchoring national mitigation pledges and taking initial steps to strengthen finance, transparency and other elements of the multilateral climate framework. Since the Cancun Climate Conference, CDM has been witnessing several reforms which would change this mechanism over time, particularly for China, India and Brazil. These changes were further strengthened at COP 17 in Durban and COP 18 in Doha.

There are a number of approaches that may be created in developing countries where they have the ability to develop their own emissions trading schemes. Options include a baseline and crediting approach that sets a target for an entire sector of the economy but does not impose mandatory caps on industry as a whole.

In the background of such transformations in the carbon market, this study seeks to gain an understanding of the viewpoints of CDM experts operating in India. It delves into the issues related to CDM reforms called upon post the Cancun Conference, and their impact on the functionality of CDM. The study also tries to understand the potential impact of the Durban Conference on the post 2012 CDM market in India and highlights the expectations of the experts from the New Market Mechanism (NMM) defined at COP 17 in Durban in December, 2011.

Objectives of the Study

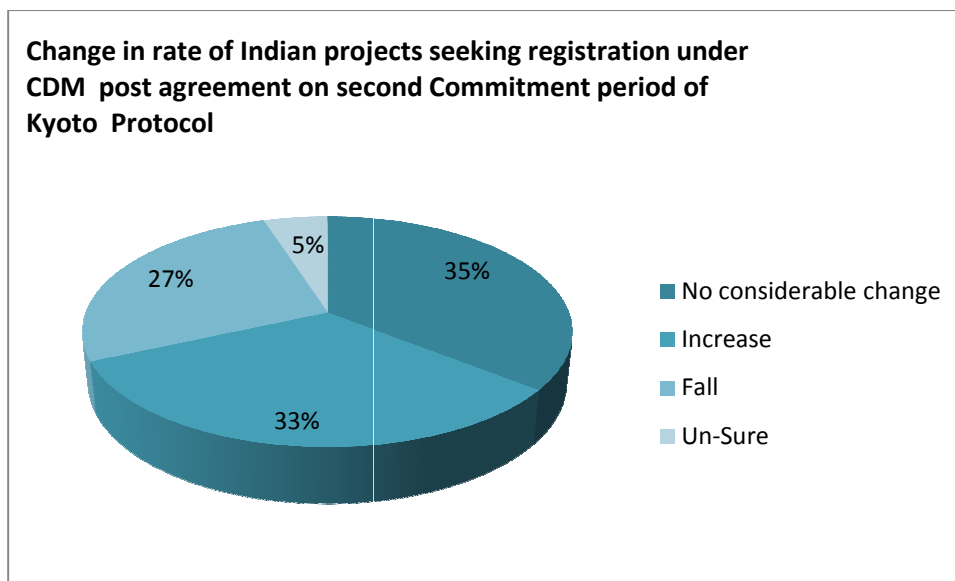
For India, which is the second largest contributor of Certified Emission Reductions (CERs) in the carbon market, significance of market based mechanisms is undoubtedly enormous. Keeping in view the potential of CDM projects and plausible revenue from carbon credits for the Indian industry, the objectives of this study were to do the following:

1. Understand the current status of CDM in India and consolidate the viewpoints of the CDM experts on the tentative impacts of the Durban Conference outcomes on the post 2012 CDM market in India.
2. Study the opinions of CDM experts on the impacts of the revised procedures introduced post the Cancun and the Durban Conference on the functionality of CDM
3. Gauge the expectations of Carbon market players from the NMM defined at the COP 17 in Durban in 2011 and COP 18 in Doha, in December, 2012.

Expectation from CDM post 2012

Till the Durban Climate Conference held in December, 2011, there was anxiety and confusion among CDM market players regarding the fate of this mechanism post 2012. With the decision in COP 17 and COP 18 to extend the Kyoto Protocol, uncertainty regarding future existence of CDM came to an end.

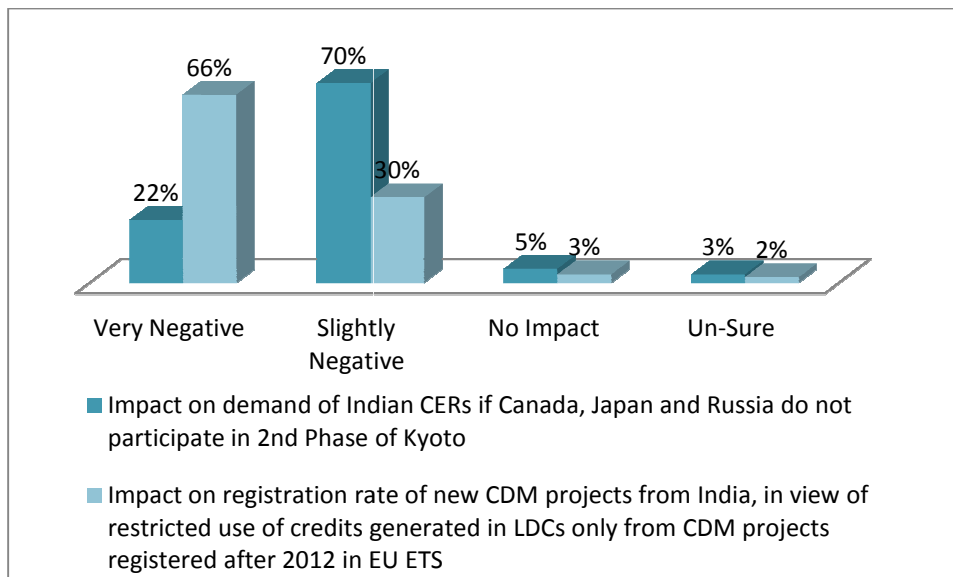
It was expected that market would react to this outcome with a significant amount of optimism. In order to gauge this market response, CDM experts were asked about the influence of this outcome on the number of projects seeking registration from India. Surprisingly, only 32% of the respondents expected an increase in the number while 27% expected a fall.



Any market is regarded to be sustainable as long as there is sufficient demand which is supported by adequate supply. In case of carbon market, the European Union (EU) and Japan are the biggest buyers of CERs generated from Indian CDM projects.

In view of this market situation, any reduction in demand of CERs from these buyers would impact the Indian CDM market very negatively. At the Durban Conference in 2011, Japan, Canada and Russia showed reluctance in participating in the second commitment period of Kyoto Protocol, starting from 2013. Moreover, article 11 a(7) of EU ETS Directive and Article 5(3) of effort sharing decision, limits the acceptance of CERs generated from projects registered post December 2012 in European Union Emission Trading Scheme (EU ETS), to those located in LDCs. Thus, when participants were asked about the possible impact of non-participation of Japan, Canada and Russia on Indian CDM market, 70% of them believed the impact would only be 'slightly negative' while only about 20% anticipated a 'very negative' impact.

On being asked about the restriction of CERs generated in non-LDCs by EU post 2012, about 70% anticipate a 'very negative' impact on Indian CDM market. Their response is in line with expectations as EU is a bigger buyer compared to Japan, Canada and Russia put together.



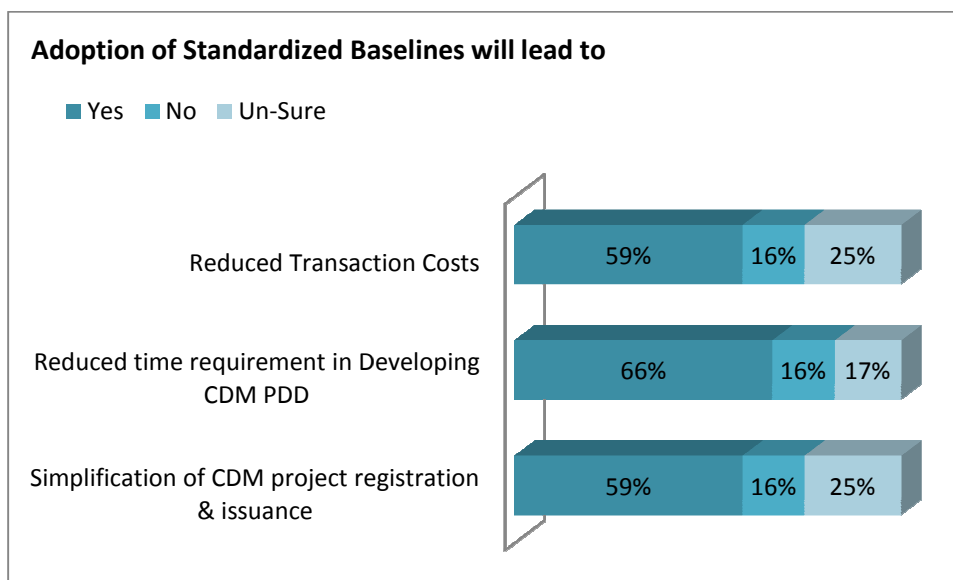
Reformed CDM post-2012

Several inherent shortcomings have often been pointed out in the CDM framework. In order to remove the shortcomings, many reforms and changes have been brought about by the Executive Board (EB) over the past few years. However, certain decisions taken since the Cancun Conference are expected to bring about still more changes which would be effective mainly after 2012.

Around 90% of the survey respondents believe that the current CDM framework is plagued by the issue of complicated operational procedures. Therefore any new reform, which is well-thought out, should not further complicate the operational procedures.

After 2012, a new regulatory framework will be implemented based on the Project Standard (PS), Validation and Verification standard (VVS) and Project Cycle Procedure (PCP), including new and revised guidelines and forms. On the question of how this new framework would impact the CDM operational procedures, about 40% of the respondents believe it would simplify the procedures, while about 30% expect further complication. 38% of the respondents expect more time delays resulting from the new framework while 35% are still unsure about its impact.

Another decision adopted since the Cancun Conference is development of standardized baselines. This decision has been perceived by the survey respondents with a lot of optimism. Majority of the respondents believe that adoption of standardized baselines would lead to much required improvements. About 60% believe it will result in reduction of transaction costs associated with CDM project development, as well as simplification of procedures of CDM project registration and issuance. A significant percentage of respondents (67%) also anticipate a reduction in the time taken during Project Design Document (PDD) development.



Another important aspect of CDM regulatory framework is the issue of providing an appeals procedure to the stakeholders by the CDM EB. The fact that stakeholders cannot raise an objection to the decision (whether rejection or acceptance) taken by EB, has been voiced as a cause for concern on various occasions. Even at the Durban Conference, a decision on an appeals procedure was deferred, much against the expectations of the stakeholders. As per this survey, a large majority (81%) of the respondents support provision of such an appeals procedure.

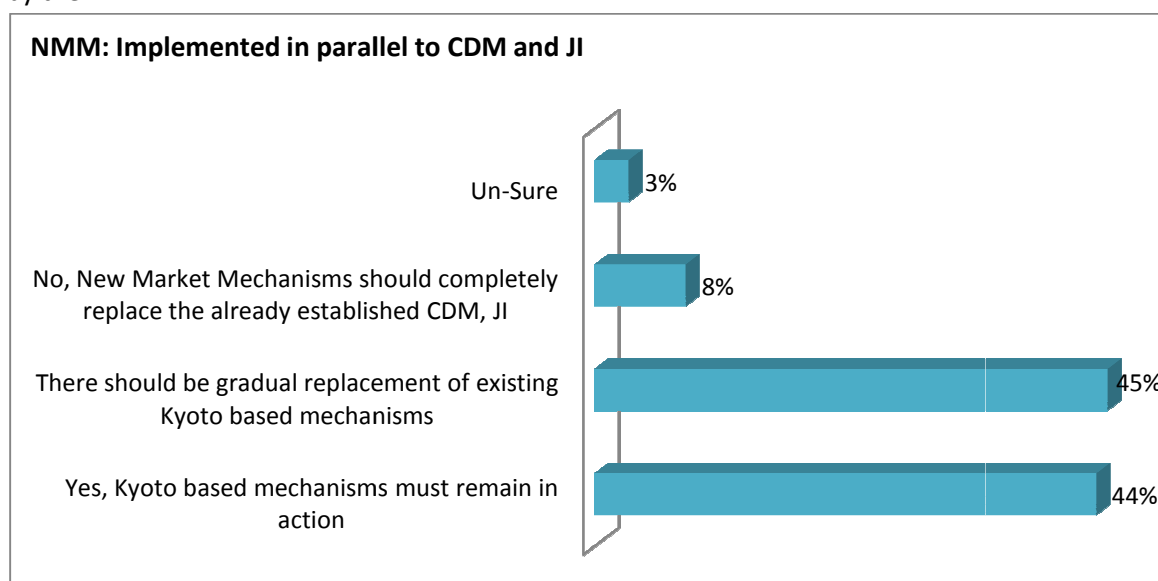
Transition to a New Market Mechanism

It is widely accepted that the current market for primary CDM has dropped to its lowest level since 2004. The collapse of the carbon markets and the focus of the Doha conference on making an agreement on the second commitment period of the Kyoto Protocol sidelined the New Market Mechanisms issue during the Doha negotiations. Essentially, rule-setting for the NMM was deferred to the 2013 COP in Warsaw. However, Doha confirmed that NMM should include both project-based and sectoral approaches, and should also be allowed for compliance with Kyoto commitments. A revival of the NMM negotiations depends on the overall fate of the global carbon market during 2013.

The Durban Climate Conference acted as a beacon to a NMM which would define the future of the global carbon market. UNFCCC called for individual submissions to understand the expectations of the governments, international agencies, financial institutions and different research organizations from the NMM. Most of the submissions supported the launch of a sector based mechanism, mainly sectoral crediting, sectoral trading or Nationally Appropriate Mitigation Action (NAMA) crediting.

In order to assess the expectations of the Indian CDM experts, the survey asked them which among the above three mechanisms, has a greater chance of gaining global acceptance and approval as NMM. About 40% expect NAMA crediting to be favored as the future NMM.

Another issue raised in the survey was on launch of the NMM in parallel to the current established mechanisms under the Kyoto Protocol. If it is launched in parallel, clear boundaries between these mechanisms would have to be established in order to avoid issues like double counting. The survey respondents were almost equally divided on this issue. While 43% support parallel implementation of the NMM, 46% believe there should be a gradual replacement of the existing Kyoto based mechanisms by the NMM.



Another relevant issue is about the fungibility of credits generated from different market mechanisms (CMIA 2012). In a scenario where different regional market mechanisms are functioning in parallel with the global NMM, there is a need to work towards making all the emissions reduction units eligible across different market mechanisms. In order to assess the views of Indian CDM experts on this issue, they were asked if there is a need to work towards the fungibility of the credits generated so that credits can be traded across different market mechanisms. A strong majority (87%) of participants considered the matter to be of extreme importance.

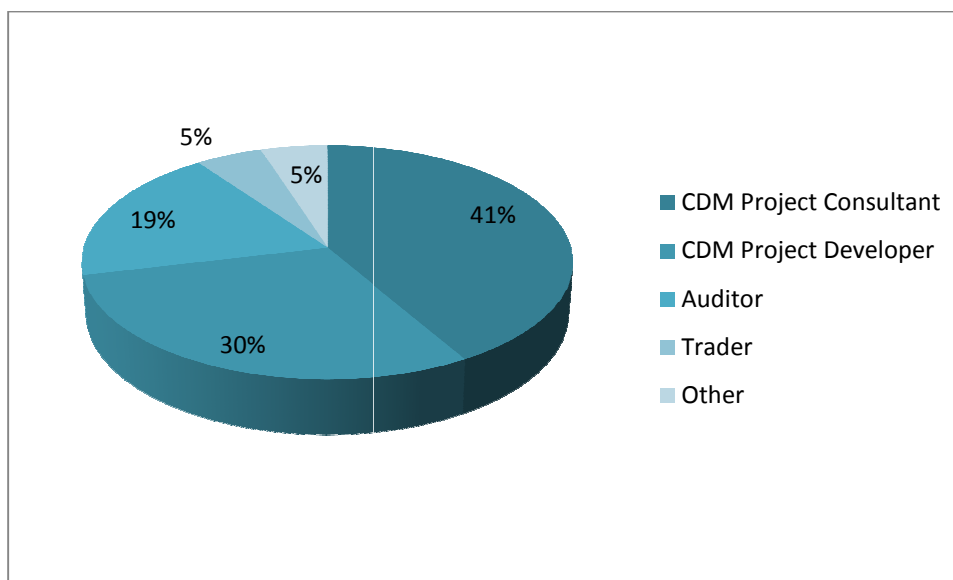
Limitations

The survey deals with a very relevant issue and is quite contemporary in nature. The theme is very timely as it helps in delving into the level of uncertainty the carbon market is undergoing in this transition phase underscored throughout 2012.

However, the survey has a few limitations. Since it was voluntary in nature, response was not received from everyone who was invited, although CDM experts who have responded to the survey include consultants, project developers, auditors, traders etc. Therefore the results may not be statistically representative; but they do give a good insight into the expectations of the CDM experts.

About the Survey

The survey questionnaire was released to key Indian carbon market players and about 90% of respondents are from the Indian sub continent. There is some representation from countries like Finland, Japan, Singapore, Netherlands and Thailand, each being less than 2% of the total respondents. Out of 170 CDM experts approached, responses were received from 64. Respondents to the survey fall into five categories as shown below:



Survey Questions

Issues covered in the survey included:

1. Current CDM Framework: Plagued by complicated operational procedures?
2. Use of Standardized baselines: will it help in reducing transaction cost of CDM project development?
3. Standardized baseline: simplify or complicate CDM projects registration and issuance?
4. Materiality Standard: will it help enhance the environment integrity of CDM?
5. Impact of market speculation on restricted use of credits generated only from LDCs in EUETS
6. Impact on Indian CERs demand in view of reluctance of Canada, Japan and Russia to participate in 2nd commitment period of Kyoto Protocol
7. Preferred approach to New Market Mechanisms: sectoral crediting, sectoral trading or NAMA crediting
8. NMM: should it be implemented in parallel to existing Kyoto mechanisms?
9. Need to work on fungibility of generated credits to be able to trade them across different market mechanisms?

Notes

In a number of questions, choice of multiple responses to several questions was permitted. The graphs are based on the total number of responses, while findings explained in the text indicate the proportion of individuals who selected a particular response.

Acronyms

CDM	Clean Development Mechanism
CER	Certified Emission Reduction
CMIA	Climate Markets and Investment Association
COP	Conference of Parties
DNA	Designated National Authority
EB	Executive Board
EU ETS	European Union Emission Trading Scheme
JI	Joint Implementation
KP	Kyoto Protocol
LDC	Least Developed Countries
NAMA	Nationally Appropriate Mitigation Action
NMM	New Market Mechanism
PCP	Project Cycle Procedure
PDD	Project Design Document
PS	Project Standard
UNFCCC	United Nations Framework Convention on Climate Change
VVS	Validation and Verification Standard