

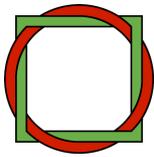


JIKO **WORK** **SHOP**

20 June 2013, BMU

Stabilising the CDM Market

Expert Discussion Session: An Analysis
20 June 2013, German Environment Ministry, Berlin



Wuppertal Institute
for Climate, Environment
and Energy

Disclaimer

This analysis takes in the discussions held at a half-day expert session at the German Environment Ministry on 20 June 2013. The statements it contains have neither been approved by the Federal German Government, nor do they represent the opinion of the Wuppertal Institute.

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Nicolas Kreibich, Wolfgang Sterk,
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Executive Summary

- The debate on measures to rescue the CDM has shown that of the numerous theoretical options put forward, only few have the potential to stabilise prices in the short term. These options include the tightening of Annex I reduction targets, discounting certificates (either at the time of their issuance or on the part of the buyer or host country), and the use of international climate funds to purchase excess CERs via the Green Climate Fund or other organisations. However, if these options are to be implemented, far greater political will is needed than is currently available, which is why it is only possible to work on the basis of a 'residual' market.
- The expert discussion session looked at which components of the CDM should be retained as a matter of urgency. To this end, all participants thought that host countries capacities should be given priority to enable project development, and the measurement, reporting and verification of emission reductions. Many participants assign the CDM Executive Board's methodology development instrument a key role.
- Session participants analysed various options for structuring the foreseen residual market. Targeted use of the funds for a limited number of projects was identified as the preferred alternative to across-the-board support.
- In structuring this market, two possible approaches were discussed: To prevent the stoppage of projects which would have no other source of revenue apart from CERs, CERs from those projects should be bought up (these include nitric acid and HFC projects). However, this is only seen as a short-term emergency initiative designed to prevent what would otherwise be the release of significant amounts of greenhouse gases. In the medium term, these emissions ought to be transferred to a regulated instrument outside the carbon market. In the case of HFCs, as part of the Montreal Protocol. In addition, importance would be placed on preventing the stoppage of projects without allowing the operators further windfall revenue. Only the actual abatement costs are to be financed.
- The second model would support new 'good' projects in order to boost the expertise of project developers and consultants in the host countries.
- To identify 'good' projects, a list of criteria needs to be drawn up. This could include additionality, co-benefits achieved, contribution to transformative effects in the host country, and integration into sectoral/national strategies. As a starting point, existing criteria could be applied such as the CDM Gold Standard or the Belgian Tender sustainability criteria.
- In addition, innovative approaches such as standardised baselines (SBLs) and Programmes of Activities (PoAs) should be promoted, including with a view to the transition to new (sectoral) market mechanisms. The expertise already available within the UNFCCC should be used to enhance these methodologies.
- Support for new projects should not only focus on the characteristics of the project concerned, but also on the host country. While no support is needed by certain emerging economies that are already on the way to establishing emissions trading schemes, other countries – especially LDCs – are in urgent need of help. Because the expertise gathered there would otherwise be lost, the support provided should focus on projects conducted in such countries. Where appropriate, support could include projects conducted in countries that have a certain amount of

capacity but where only individual projects have been carried out so far and where the CDM knowledge had not yet been transferred to other areas of application.

- The institutional structure, rules and processes established by the UNFCCC should be used and maintained in order to counteract a 'race to the bottom' in terms of quality arising from continuation of centralised standard-setting by the CDM.
- Use of climate finance to stabilise the CDM and use of the MRV structure established with the CDM for climate finance provide key opportunities for synergies. These benefits must, however, be weighed against the high transaction costs involved in the CDM's MRV system. A range of different financing models were identified with which private capital could be mobilised for use in climate finance.

1 Discussion Objectives and Agenda

1.1 Objectives

Against the backdrop of dwindling prices for emission certificates from CDM projects and the risk of destabilisation of the global carbon market, the Federal German Ministry for the Environment, Nature Conservation and Nuclear Safety (BMU), with support from the Wuppertal Institute, held an expert discussion session on 20 June 2013 on the subject of Approaches to Stabilise the CDM Market. The main focus of the discussion was to identify the options available to safeguard and maintain CDM institutions and expertise in order to enhance the CDM and establish new market-based mechanisms for use in a climate change regime beyond 2020.

- Which CDM institutions and what expertise should receive support and be promoted?
- What role can climate finance play in stabilising the CDM?
- Summary of the findings and recommendations, and concluding address by the hosts.

1.2 Participants

A total of 16 people took part in the expert discussion session. Along with the project team from the Wuppertal Institute and members of the German Environment Ministry (BMU), the attendees comprised representatives from industry (BDI), banking (Commerzbank, KfW), project development (GFA, First Climate), and research and consultation (Ecologic, Climate-Focus, Ecofys).

1.3 Agenda

The agenda for the meeting was as follows:

- Welcome address and introduction
- Options to stabilise the CDM

2 Presentations

The participants were first treated to presentations on two studies. Wolfgang Sterk of the Wuppertal Institute presented a policy paper¹ the institute had drawn up on behalf of the BMU. Carsten Warnecke (Ecofys) then presented a study conducted jointly by Ecofys and Climatekos and commissioned by KfW Bank².

The paper presented by Wolfgang Sterk, **Options and Ideas to Stabilise CER/ERU Prices**, put forward various proposals on stabilising the market. These included proposals with little chance of being implemented. All proposals – a total of eight measures from the demand side and six options from the supply side – are subjected to qualitative analysis based on the following criteria: The (short-term) quantitative effects on the supply and demand ratio, long-term pricing signals and political and market acceptance.

Of the fourteen options, three measures were identified as having the potential to effect significant, short-term effects on the supply/demand ratio: The tightening of Annex I reduction targets, discounting certificates (either at the time of issuance or by the buyer or host country), and the use of international climate finance to purchase excess CERs via the Green Climate Fund or other funds.

The paper presented by Carsten Warnecke, **CDM Market Support Study**, has three parts. Part A looks at the transaction and marginal

abatement costs of various project types to reveal their sensitivity to and dependence on fluctuating CER prices, and classifies them into three separate categories. Part B of the study analyses and classifies financing instruments designed to support projects based on five criteria. Part C analyses policy-based measures for market and price stabilisation.

In contrast to the policy paper from the Wuppertal Institute, which lists a wide range of possible options, the Ecofys study focuses on a selection of options whose implementation is deemed realistic. This selection includes the establishment of a demand window in existing carbon markets, the activation of new buyer sources (new emission trading schemes and voluntary buyers), as well as purchasing options via (public) institutions.

The creation of a buyer niche in existing markets has, however, lost some of its relevance as a result of the low price levels – it is uncertain whether the price that applies in the niche would be higher than the extremely low price for EUAs.

Activating new demand sources by establishing regional niches is, by way of contrast, seen as extremely important. Countries and federal states could receive support from the creation of the components (institutions, expertise and processes) necessary to generate future demand.

Purchasing activities via (public) institutions are also highly promising. Emission reductions achieved under the CDM's strict MRV conditions could be used for results-based financing. They could also be used as NAMAs where expectations in respect of MRV are high. Results-based finance could help save the CDM and pave the way for new mechanisms.

¹ Hermwille, Lukas (2013): *Stabilizing Regulated Carbon Markets – Options and Ideas to Stabilize CER/ERU Prices*. JIKO Policy Brief. Wuppertal: Wuppertal Institute for Climate, Environment and Energy.
URL: www.jiko-bmu.de/1289 [viewed 11.06.2013].

² Warnecke, Carsten; et al. (2013): *CDM Market Support Study*. Ecofys.
URL: <http://www.ecofys.com/en/publication/cdm-market-support-study> [viewed 22.07.2013].

The findings of the study indicate that there is no 'silver bullet' option to solve all problems. Rather, each option has its pros and cons. Given the urgency, short-term measures such as purchasing activities must be given priority in their implementation, and then be supplemented by long-term support measures which combine a range of different options. These measures would be seen as an interim solution and would not replace reactivation of demand. To transfer CDM knowledge to a new mechanism, the use of results-based financing appears to be the most promising option.

3 Discussion: Where should support be given?

The session participants discussed the issue of which institutions and what CDM expertise should receive support. Various components were identified which are deemed essential to the system's functioning and whose reactivation could be both expensive and time-consuming.

All participants saw the main focus on **maintaining capacity and structures in the host countries** to allow development of projects and the MRV for emission reductions, and in particular the **project developer and consulting capacity**. The great importance attached to capacities in host countries can be seen in that they have acted as key drivers in the establishment of national emissions trading systems in developing countries.

The role of the UNFCCC-developed capacities, structures, rules and processes was discussed in detail. While some participants thought that the institutional structures of the CDM could be abolished and that the UNFCCC could be reduced to a point of contact for FAQs, as the discussion progressed, various functions were identified that underline the importance of these structures and the need to maintain them.

Thus, **the UNFCCC structure and its processes could serve as the standard** to ensure transparency and prevent loss of quality. The CDM methodologies have, despite verbal distancing, been used in new emissions trading systems, meaning that in this instance, the UNFCCC has served as a standard-setter and has thus prevented a race to the bottom. The role of the UNFCCC structures in linking

emissions trading systems was also the subject of heated discussion. While one side proposed making linking possible via a dedicated institution outside the UN, other participants stressed the importance of the credibility earned by the UNFCCC as a result of its policy legitimisation – something exclusively private actors cannot achieve. In particular, quality control by the UNFCCC is of key importance in the linking of systems in countries with low MRV capacities.

In this respect, **the importance of the UNFCCC as a methodology innovation engine** was emphasised. To ensure the further development of methodologies and processes, a certain level of staffing and size must be maintained in the CDM institutions. Otherwise, it would only be possible to administer what has already been achieved. If the UNFCCC structures were to be downsized, the potential for methodology design would be severely limited. In fact, according to one participant, given the considerable effort needed in developing standardised baselines, both institutional and staffing capacities at the UNFCCC would need to be expanded to allow methodologies to be further developed and enhanced. Also, many countries lack the necessary structures for methodology design, making external support a must. With its vast experience in MRV, the UNFCCC is perfectly suited to tackle such tasks.

Maintenance and further development of the methodology instrument is especially important when it comes to developing a new market mechanism. According to one participant, the combination of a standardised baseline and the programme of activities

approach is almost a new market-based mechanism in itself. In addition, there is little consensus as to where these methodologies are to be further developed: While some see the UNFCCC structure as indispensable, others proposed methodology design outside the UN framework.

With support from the CDM, **DOE capacity** could also be maintained. This was considered crucial to enable transparent processes and guarantee high standards. Yet in order to meet these requirements, a market-driven reduction in the number of DOEs is thinkable.

Maintaining these capacities, however, only makes sense if it can be expected that a market will exist in the future. Among the participants, there was a general expectation that this could be reasonably assumed. The timeline for such a development remains uncertain, and the **likelihood of a new market being created in the near future was seen as slight.**

Some participants pointed to the fact that the situation regarding the trade in **CERs generated by projects in least developing countries (LDCs)** differs greatly to that of the CDM in general. This market, which is currently dominated by state activities, is not yet saturated, unlike the CDM market. With additional capacity-building activities on the part of the EU, this market could be strengthened further.

In the discussion on the measures to save the CDM, participants pointed to the myriad interests and incentives of the market players involved, and hence to the **great differences in people's motivation** to either help save the market or be saved themselves. For example, the workshop on CDM Modalities and Procedures held in Bonn from 8 – 9 June showed that, unlike numerous LDCs, most emerging economies had little interest in further developing the CDM. In this regard, the importance of coalitions between the various

market players was stressed because the work involved was too much for a single country.

4 Other Discussion Topics and Recommendations

The discussion on which components of the CDM should be saved ended in the drawing up of wish lists and recommendations for implementation of the goals defined during the talks. Some of these recommendations are addressed in the following sections, taking account of what was discussed.

4.1 Quality not Quantity

A general recommendation was to prioritise support quality above support quantity. This was based on the critical evaluation of across-the-board purchase of CERs, as had been proposed by Vivid Economics.³ It was pointed out that using this method to buy CERs from existing projects merely paid for the transaction costs. The associated expertise was not necessarily retained and the climate benefits might only be marginal in relation to the level of investment.

Rather than using the watering can principle to provide a large number of projects with only marginal funding, it would be better to support a limited number of projects by providing them with sufficient financial resources. How such support might look was further defined during a discussion on the design of potential funds. Examples were given by participants from

Sweden and Great Britain. Sweden supports projects and provides them with the financial assistance they need, while Great Britain uses the World Bank to assist selected projects. Participants saw these different approaches as showing the way to go.

4.2 Two-Pronged Support

With regard to activities to support the market, participants proposed two different approaches.

4.2.1 Approach 1: Purchasing CERs

The first recommendation involved purchasing CERs from projects which, apart from CERs, have no additional source of revenue and are thus at risk of being abandoned, e.g. nitric acid projects, HFC projects, and certain landfill gas projects. It was estimated that this would generate a volume of around 200 million CERs per year for nitric acid and HFC projects.

The aim of this measure would be to prevent the projects from being stopped and thus avoid the release of significant quantities of greenhouse gases. This is, however, seen as a short-term emergency solution. In the medium term, these emissions should be transferred to a regulated system outside the carbon market. In the case of HFCs, this could be a system under the Montreal Protocol. In addition, it is important to prevent projects from being stopped without allowing operators to gain further windfall revenue. The measure should only be used to finance actual abatement costs.

³ Vivid Economics (2013): The market impact of a CDM capacity fund, Final Report, June 2013. London: Vivid Economics. URL: <http://www.vivideconomics.com/index.php/publications/the-market-impact-of-a-cdm-capacity-fund> [viewed 11.07.2013]

In this regard, the use of **reverse auctions** was discussed. In doing so, participants agreed that it makes no sense to use reverse auctions for existing certificates. However, they could be used for new issuances and new projects. With the help of reverse auctions, knowledge could be gained as to the type of support project developers actually need in order to continue with their projects given that they are dependent on the revenue from the sale of CERs (e.g. nitric acid projects).

The introduction of a minimum price met with scepticism among participants. How high or low should the price be set? If it is set too high, it equates to taxation. If it is set too low, it has no impact. Against this backdrop, the introduction of a minimum price was not thought to be the ideal solution.

In this context, it was made clear that for the foreseeable future, no funding would be made available for this type of measure. Also, participants feared that, in the event of a sudden price increase, the allowances currently being held back could flood the market with additional CERs because the CER prices at present are below issuance costs. Participants agreed that support measures could merely serve as an interim solution in order to ease the way for the private sector to enter the market later down the line.

4.2.2 Approach 2: Support for new projects

The second approach should support the implementation of new projects. The aim behind such support would be to maintain the CDM structure, particularly in host countries. To enable the provision of targeted support, participants recommended defining quality criteria. In doing so, the following criteria were proposed as the basis for developing a list of criteria: Co-benefits, financial necessity of the support, additionality, contribution to trans-

formative change in host countries, and the exclusion of double counting.

Defining ‘really good projects’

There was consensus on the need to place great importance on the definition of good projects. However, it was noted that their identification could be difficult and cost-intensive. To reduce the effort and the costs involved, participants proposed using available experience with existing approaches. Particular reference was made to the Gold Standard and the Belgian CDM Tender sustainability criteria.

Accelerating innovative approaches (PoAs/SBLs)

Support for new projects should, according to participants, be seen against the backdrop of continued development of innovative approaches like the Programmes of Activities and Standardised Baselines. These measures play a key role in implementation of future measures. While both models are already well advanced, they are not yet suitable for transfer to sectoral or national mechanisms.

4.3 Defining Project Types for Acceptance in Emissions Trading Schemes

A further recommendation was made in respect of linking emission trading schemes. To promote use of the CDM in these new schemes, project types should be identified that are acceptable by all players as the smallest common denominator. This recommendation was discussed against the backdrop of what has up to now been the rather limited role of the new emissions trading schemes as markets for CERs and ERUs – a subject that had already been discussed in great detail. Reasons for the limited role of ETSS as markets for CERs were

seen both with the CDM and with the new ETSs themselves. Thus, the damaged reputation of the CDM was seen as an underlying problem in the use of the CERs in new ETSs. Also, the CDM is seen as too bureaucratic and complex, which detracts from acceptance of CERs. This is evident in that the emerging ETSs have already developed their own structures. Taking California as an example, it was pointed out that the volume and the basic rejection of the transfer of funding to other countries are seen as the cause for non-acceptance of CERs.

The likelihood of the CDM being used in the linking of emerging emissions trading schemes was seen by some participants as marginal. It therefore appears likely that new schemes may adopt procedures from the CDM but not its structures. This makes intensive exchange on emissions trading systems necessary in order to achieve compatible rules on the use of offsets.

4.4 Defining Country Groups

The definition of country groups was proposed as a further measure for targeted support in the implementation of new projects. This would allow segregation of country groups relative to the amount of support they need. Three groups were identified.

Group 1

This group contains those countries which are no longer dependent on support and are already in the throes of establishing their own emissions trading schemes.

Group 2

This group consists of countries, particularly LDCs, in which the CDM structures are not yet properly established. Projects should thus be supported in terms of capacity-building and to retain the methodology expertise gained so far.

Group 3

This group comprises those countries that belong neither to Group 1 nor Group 2. These are countries in which individual, support-dependent projects would be conducted.

4.5 Use of Climate Finance

Climate financing was seen as an important option in stabilising the CDM. The MRV system developed with the CDM could also be used to provide results-based financing. These benefits must, however, be weighed against the high transactions costs involved in the CDM's MRV system.

The availability of adequate **funding resources** was identified as a vital criterion for a fund to provide results-based finance. Thus, a sufficiently broad-based fund would make it possible to simulate a market. In light of this option, participants discussed whether a **market-based model or project financing** based on individual prices would be preferable. In doing so, they identified the search function of the market and also the ability to mobilise private capital as key advantages of the market-based approach. The session participants looked at various proposals and cited examples of how funds should be designed in order to meet these goals.

One particular proposal the participants discussed was the creation of an **investment guarantee fund**. A participant stressed that for countries with extremely high investment risk, the provision of secure credit could be enough to mobilise the private capital needed for project implementation. In this respect, the **Japanese model** was discussed, in which private capital is leveraged by export support.

Asset-backed securities are another possible option. Projects would be divided into three tranches: Debt, equity and a first loss tranche. Because risk distribution would vary, a lot of

private capital could be leveraged with this approach. The first loss tranche could, for example, be equipped with funds from the Green Climate Fund or with bilateral climate financing in the form of pre-financing the anticipated CERs. This would place the greatest risk with public financing, which would call for careful project selection. In this regard, it was assumed that numerous funds would exist in future, and that they would be extremely unlikely to coordinate their responses.

Participants also discussed the creation of a **fund based on the World Bank's Prototype Carbon Fund (PCF)**, which in the early stages of the project-based mechanisms secured their implementation by securing investors for CDM and JI projects. The very different prevailing circumstances were, however, emphasised: The PCF was created with the entry into force of the Kyoto Protocol and was thus able to mobilise capital from governments and private enterprise.

4.6 Regaining Trust

Some session participants underscored the importance of trust in the mechanisms. Regaining this trust must be a key objective in implementing the above measures.

Participants

Institution	Name	Surname
Ecologic	Matthias	Duwe
BMU	Miriam	Faulwetter
BMU	Thomas	Forth
ClimateFocus	Sandra	Greiner
BDI	Joachim	Hein
First Climate	Markus	Hüwener
BMU	Silke	Karcher
DEHSt	Karsten	Karschunke
Wuppertal Institute	Nicolas	Kreibich
KfW	Nils	Medenbach
Commerzbank	Ingo	Ramming
Freier Consultant / EB	Lambert	Schneider
GFA	Joachim	Schnurr
Wuppertal Institute	Wolfgang	Sterk
BMU	Luise	Voget
Ecofys	Carsten	Warnecke
Wuppertal Institute	Timon	Wehnert