Summary Report of the Ministerial Dialogue about the role of market mechanisms under UNFCCC

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The Ministerial Dialogue about the role of market mechanisms was convened on Tuesday 4 December at COP 18 in Doha, Qatar.

The Dialogue was attended by:

- Mr. Mark Dreyfus, Parliamentary Secretary for Climate Change and Energy Efficiency, Australia
- Mr. Xie Zhenhua, the vice chairman of NDRC, China.
- Mr. Jos Delbeke, Director General for Climate Action, European Commission.
- Ms. Katherina Reiche, Parliamentary State Secretary for Environment, Germany.
- Mr. George Prime, Minister, Grenada
- Mr. Hiroyuki Nagahama, Minister of the Environment, Japan
- Ms. Nandi Mayithula Khoza, Provincial Minister for environment, South Africa
- Mr. Ken Newcombe, CEO of C-Quest Capital
- Mr. Rupert Edwards, Managing Director, Climate Change Capital
- Ms. Joan MacNaughton, Vice-chair for the High-Level Panel for the CDM Policy Dialogue

The event was moderated by Lord Nicholas Stern.

The meeting was introduced by Lord Stern, who explained that the purpose of the Ministerial Dialogue is to share ideas and views about if and how market mechanisms have a role under UNFCCC.

Joan MacNaughton set the scene for discussions, by providing an overview of recommendations and main messages from the CDM Policy Dialogue. She highlighted that the CDM has proven to be a valuable tool contributing to finance and emission reductions under the convention, but also has problems that need to be addressed. She mentioned that the CDM is in acute crisis and that parties must take action if they wish the CDM to remain. She emphasized four messages: 1) Parties must increase ambition to create the demand for the CDM to function – or indeed to make any market mechanism to function; 2) the CDM has a significant potential to interact with other tools under the convention, such as the Green Climate Fund and NAMAs, and also serve to avoid fragmentation of global carbon markets. However, the governing bodies of the CDM must start working with other bodies and mechanisms if this is to happen; 3) The CDM can and should be expanded to encompass new sectors, to move into net mitigation, and to allow anybody to use the emission reduction units generated by the CDM; 4) There is a need for reforming the CDM's operations and governance.

The moderator then invited short comments from each of the discussants:

Mark Dreyfus stated that carbon pricing is key to allow countries to achieve ambitious mitigation objectives, and that this is an underlying rationale for Australia's recently adopted carbon pricing mechanism. He mentioned that the future growth in market mechanisms will be driven by jurisdictions individually and jointly, although, mechanisms designed and operated under the UNFCCC will continue to have a role.

Mr. Dreyfus referred to the report of the high-level Panel for the CDM Policy Dialogue, saying that among many reported benefits of the CDM are poverty alleviation, the promotion of reliable and renewable energy and capacity building. The CDM also gives governments and local businesses experience with carbon markets. He said that Australia hopes to see the CDM continue to improve and that the high-level Panel's recommendations are given due consideration, in particular in relation to governance and access. He stated that the framework for various approaches (negotiated under AWG-LCA) will integrate mechanisms in a manner that coordinates and gives transparency to their operation and builds confidence in their environmental integrity, and that as much groundwork as possible for the framework should happen in Doha.

Jos Delbeke said that the EU emission trading scheme has demonstrated that cap and trade mechanisms can be very efficient. He commented on the many new and emerging emission trading schemes around the world, and said that they will flourish, but only if there is a balance between supply and demand. He said that the CDM provides a de facto-linking of these schemes, and that it is important that cap and trade systems that are open to CDM. One of the key issues is to ensure common accounting methods, so as safeguard against double counting of emission reduction units. Mr. Delbeke then elaborated on his views on the new market mechanisms (also negotiated under AWG-LCA), saying that it should function primarily as a sectoral approach, which would bring it beyond the project based mechanism. He concluded by saying that the EU remains a strong supporter of the CDM, that the EU emission trading is open to the CDM and will continue to provide significant demand for CDM credits.

George Prime noted Grenada's concern that the CDM, and indeed the entire carbon market infrastructure, appears to be on the verge to collapse. He said that placing a price on carbon and developing robust carbon markets internationally is an essential component of global mitigation effort. He linked this to the 8 Giga ton gap, stating that markets must play a significant but supplemental role to facilitate a rapid increase in mitigation ambition. Mr. Prime said that the CDM has been an extraordinary success, but that the lack of regional distribution remains a challenge. He called for integration of the existing mechanisms with the new market mechanisms, new markets, and NAMAs, in a manner that protects environmental integrity, provides transparency and sound accounting rules, has a robust MRV system in place, and a compliance mechanism governed by the Conference of the Parties. He said that a key deliverable for Doha should be a smooth transition into the second commitment period with countries moving swiftly to ratify the needed amendments to the Kyoto Protocol. A second important delivery would be a clear signal to the entire world that all countries, but in particular developed countries, under common but differentiated responsibilities, are prepared to increase the level of ambition. He concluded that increasing demand is the best price signal that we can send to the carbon market.

Katherine Reiche set out five key points for successful outcome for market mechanisms in Doha: First an agreement of binding targets for the second commitment period of the Kyoto Protocol; Second, ensuring a seamless transition of agreement on transition of CDM and JI into the second commitment period; Third, progress in rule settings for the new

market mechanisms; Fourth, good preparation of the CDM review process by the CDM Executive Board; and fifth, rules for handling of AAUs from the first commitment period so that the revival of the carbon market is not hampered by displacement. Ms. Reiche reflected on the need for carbon prices to meaningfully reflect the underlying cost of investments and mitigation measures. While the recommendation by the high-level Panel to increase ambition is justified, it is not possible to create stability on the carbon market, unless a comprehensive and ambitious climate protection treaty is adopted in 2015, to enter in force in 2020. She said that until now, the CDM has been inadequately linked to the political priorities of the host countries, and insufficiently involved for example, in low carbon strategies and plans by the host countries, and that a reformed CDM could address this. She emphasized that the CDM has been a success, and indeed improved much in recent years. Still, more must be done, in particular with regard to defining more clearly what areas are in, and what areas are out, of the CDM. She said it would be naive to ignore the economic deadweight effect and inefficiencies that led to the crowding out of sustainable projects. Ms. Reiche referred to the importance of programmatic CDM and said that considering major difficulties associated with its implementation, it is evident that the introduction of an even more complex tool, such as a sectoral new market mechanism, will be anything but straight forward. Finally, she called for a prompt start approach for the new market mechanisms, similar to what was previously adopted for the CDM.

Zhenhua Xie stated that the rationale for market based approaches is that we want to reduce the cost of mitigation, while encouraging people to pursue emission reduction. He said that the main challenge for global carbon markets is the lack of demand. If reduction ambition is increased, then the potential of carbon markets will manifest itself. He identified differences in mitigation costs in different countries and sectors as another important driver for international markets to function. He said that the CDM is filling a dual role by providing mitigation for developed countries at low cost, and supports developing countries with investments and technology so as to promote their industrial structural adjustments and technology development in support of domestic sustainable development. Mr. Zhenhua Xie reflected on the fact that with increasing economic wealth the energy consumption and associated greenhouse gas emissions rise. Therefore it is important to both ensure basic energy access, while

also putting a price on higher levels of energy consumption. He emphasized that the priority outcome from Doha, with regard to carbon markets, is to ensure a smooth transition into the second commitment period of the Kyoto Protocol.

Hiroyuki Nagahama said that for Japan to achieve its 6% reduction target, the use of the Kyoto mechanisms provide an important supplement to domestic efforts. Japan considers that the CDM is effective and that through learning-by-doing over the past several years, the mechanism has improved. Lessons learned from the CDM should not only apply to the CDM itself, but also to other mechanisms being developed under UNFCCC. Key attributes include transparency, environmental integrity and flexibility in supporting countries with different circumstances to benefit from transfer of low carbon technologies. Mr. Nagahama said that in order to stabilize the international carbon market, it is important to reduce uncertainties for the future. Therefore the agreement in Durban to provide a framework for various approaches is essential to build this trust, and reduce uncertainties about market mechanisms used. He concluded by saying that the discussions in Doha should move us towards an agreement to be implemented in 2020, which ultimately will provide the certainty that carbon markets need to function properly.

Nandi Mayithula Khoza reflected on the fact that the central feature of the Kyoto Protocol is its requirement that countries should limit or reduce the greenhouse gas emissions. By setting such targets, emission reductions take an economic value. South Africa is hosting several CDM projects and the associated benefits – in addition to emission reductions - such as investments and sustainable development, are obvious. South Africa therefore recognizes the role of market mechanisms under UNFCCC. However, an important condition for carbon markets is that there is an agreement on mitigation targets by developed countries so as to create the demand for emission reduction units from the mechanism. Ms. Mayithula Koza mentioned that fundamental requirements for any market mechanisms is that they have a high environmental integrity and that that they meet sustainable development criteria as defined by the host countries. Ms. Mayithula Khoza said that the agenda item on various approaches, including new market based mechanisms, requires much more time for discussions among negotiators to achieve results. She believes that there will eventually be an output, but at this session, due to time constraints, we should be realistic about what can be achieved. We can all agree on the fundamentals; take mitigation action in the most cost effective manner, protecting environmental integrity, ensuring proper accounting of carbon trading units, ensuring sustainable development and being inclusive, respecting the various approaches that the different countries may have. If we can agree on how we translate these fundamentals into the framework for various approaches we would indeed have achieved a lot in Doha, she said. Finally, she stated that Africa is still under represented in the CDM for a variety of reasons, which need to be dealt with in the next commitment period.

Rupert Edwards referred to the report by Lord Stern, which shows that the cost and impact on the gross world product from meeting a two degrees trajectory is quite daunting. Carbon pricing has an important role in this regard. At the same time, Mr. Edwards said, we need to accept that compliance driven offsets are not going to play a significant role in the next few years. In that scenario results based financing can maintain carbon price signals and retain the strengths and infrastructure of the existing CDM architecture. Mr. Edwards identified the outstanding feature of the CDM as acting as a UN clearing exchange, providing a “triple A” UN credit backed revenue stream that not only addresses the externality issue but also reduces the generic financing risks and barriers that we hear so much about, including sovereign risk, policy risk, counterparty credit risk and foreign exchange risk . In addition, he said, CDM provides for comparable units of accounting in carbon dioxide equivalents and all the infrastructure of MRV. Mr. Edwards mentioned that results based financing has been agreed as a tool for driving private investments in the governing instruments of the Green Climate Fund, and could provide a way to underwrite a weak market and potentially deliberately to go out and target distribution on its use and underrepresented sectors. Mr. Edwards commented on the current proposals for a new market mechanism, saying that none of the current proposals are attractive to private sector investments because they foresee that credits are issued directly to local governments rather than to the private actors. He said that this would undermine the strength of the current system, which is precisely that it reduces the sovereign policy counterpart credit risk. Finally, Mr. Edwards identified a couple of good examples where the CDM facility could work well today in the absence of any market demand. This includes projects and programs with strong co-benefits in low income countries, such as distributed energy systems or energy access where very good health and development outcomes are correlated with climate outcomes.

Ken Newcombe remarked that an enormous amount of young talent was brought by the CDM into the market and began a really innovative journey in how to bring carbon finance to all kinds of mitigation activities. However, we now see a huge exodus of people who were part of that exhilarating period of capacity building in the developing countries and in the industrialized countries trying to make that market work. The reason is simple, he said: there is no new investment, it is completely impossible at a carbon price of less than a euro a ton. Mr. Newcombe proposed that if we are to bridge between now and the future plethora of new market mechanisms, which are essential to fulfill the vision of the Green Climate Fund, we have to preserve what we have because the entrepreneurial edge of this market has exactly the capacity that is needed to figure out how to make new instruments work for the diversity of opportunities to deploy private capital in the market. He stated that the exclusion of the CDM from the emerging emissions trading schemes is a huge mistake, and that regulators in those markets would benefit from reading the CDM Policy Dialogue report to understand the true nature of the CDM today. Regarding the idea of a CDM fund, to sustain demand in the transition period, Mr Newcombe estimated that it would cost between three and five hundred million dollars a year originating maybe a hundred million tons a year to keep the CDM alive and provide the opportunity and confidence for private capital to come back into the market when it’s established.

It would be impossible if this CDM market dies, to convince an incredibly skeptical private sector to invest again. That's a fraction of what sovereigns spent in this market in its early going, he said. He concluded by saying that the Green Climate Fund must be a vehicle for continuity for the CDM.

After these statements, the moderator, Lord Stern, asked the discussants to comment on how the threatening market collapse can be averted.

Jos Delbeke responded that this question is really about how to create demand. In his view, a second commitment period may not be sufficient to create the demand needed. So the question is how to create additional demand. Mr. Delbeke stated that from this perspective, it would be very unwise if the negotiators finalizing negotiations in the coming days will restrict access to the CDM. In this regard we should all be very pragmatic. He also mentioned links to the discussions about offsetting for aviation. He mentioned that this is an international affair, and restricting access to CDM, only to parties that have taken targets under the second commitment period, would be an opportunity lost both for the markets and f the aviation industry.

Lord Stern the asked if the EU couldn't recognize that it is in recession and reduce the allocations under the EU emission trading scheme?

Jos Delbeke responded that this is what the European Commission is trying to do, but that there is a complicated debate about that. But even if this would be successful, he did not think that this would solve the problem for the CDM.

Joan MacNaughton remarked that the CDM Policy Dialogue recommended the establishment of what was called a stabilization fund as a way of actually trying to tackle number of CERs, so that as demand comes in back in. This is a supply side solution, she recognized, and went on to say that bringing demand back in, and to bring it back in permanently, is clearly the system solution and what needs to happen for mitigation reasons. Ms. MacNaughton referred to Mr. Newcombe's statement, and speculated that sovereign funds could be interested to purchase and hold CERs until the level of ambition is such that maybe they can make a good return on them. Could the Parties here send a signal that CERs are going to be the common currency for new mechanisms in the future?

Mark Dreyfus commented that the long term strength of the CDM is uncertain in the absence of clear signals on future demand for CERs, and that for this reason it is very important that the CDM transits smoothly from the 1 Jan 2013, to allow us to know that the CDM will be fully operational, and that the ability to participate in the CDM will continue

Rupert Edwards said that he agrees that we need all what previous speakers had identified, but also increasing demand for CERs in Australia from 12,5 to 50% , as well as increasing EU emission reduction target to 30%. Mr. Edwards said that this will merely help tackle the existing oversupply. Instead, the international climate finance generally, whether that is sovereign funds, development aid budgets or multilateral mechanisms like the Green Climate Fund, should be interested in using the architecture of CDM for measuring the emission reductions, understanding the co-benefits and correlations of development outcomes with emission reductions and using competitive price discovery mechanisms to bring down payments towards incremental costs.

The moderator then invited the audience to ask questions and make comments. These included:

- Is it possible to pass a decision in Doha that will stimulate demand in period 2012-2020?.
- How can we get the carbon pricing being accepted and used as a matter of urgency?
- Do you see any possibility of monetizing CDM credits and allow them to be used under the Durban platform?
- CDM is an important tool for linking new markets and mechanisms, with the existing ones. How can this be achieved?
- How do you propose to address shortcomings of carbon markets, such as double counting, commodification of natural resources, additionality and bilateral linking of markets outside UNFCCC?
- Will you endorse the text that is currently on CMP, what other measures will you have to avoid CDM falling off the cliff?
- How can we turn CDM into a net mitigation mechanism?

Joan MacNaughton clarified that the high-level panel for the CDM Policy Dialogue recognized demand, not supply, is the real problem, and that the real solution has to be in increasing the level of ambition. Having said that, she remarked, the Panel did feel that there is a temporary problem also with the supply, hence the proposal for a CDM stabilization fund. Once you get demand back, including through increasing access, then you would see the price come up.

Mark Dreyfus said that de- linking CDM eligibility from parties' status, will help boost demand. We have a problem with insufficient demand. Australia is joining the second commitment period, but we still think that access should be there for countries which have not joined, he said.

Hiroyuki Nagahama said that the CDM is coming to an important turning point. Back in 1992, when we had the Earth Summit, the circumstances were very different than those today. The situation of the developed and developing countries today is different. So we may need to go back to the starting point, recognizing that we all need to reduce emissions, and that we all may want, or need to utilize the CDM.

Nandi Mayithula Khoza agreed that time is of essence and that we have to need to ensure there is a conclusion on this issue in Doha.

Ken Newcombe said that the missing part in CDM is the absence of CDM projects in agriculture and sustainable land use, to some extent also including forestry. CDM could very well experiment with projects in these sectors to learn if and how markets can support low carbon development in these sectors.

George Prime said that countries should not be allowed to access the CDM unless they meet the eligibility criteria. For him, the way forward is to increase the level of ambition,

Lord Nicholas Stern then summarized the meeting: First, he noted that the recommendations by the High-level Panel for the CDM Policy Dialogue were warmly welcomed. He highlighted the four main messages that Joan MacNaughton had delivered: 1) The need for increased ambition to drive carbon markets; 2) The need for integration of CDM with other existing and new instruments, to allow consistency between mechanisms, units, and markets; 3) The need for openness to allow new sectors, programs and countries to benefit from the mechanisms; and 4) The need for avoiding being unnecessarily restrictive in access to the mechanism.

Second, this ministerial dialogue had discussed options for how to avert the immediate crisis. In addition to the main message, that increased ambition is necessary, the discussants had also proposed options that sovereign buying, aviation, tightening of the EU cap, use of ODA vehicles etc,

Third, there is a shared frustration about the lack of urgency. The gap between where we are, and where we need to be is huge, and is part of the reason for the collapse of carbon markets.

Fourth, Lord Stern clarified that he, in his role as member of the Advisory Board for Climate Finance, was worried that at least half of the US$ 100 billion that was envisaged for the Green Climate Fund, was expected to come from different forms of carbon pricing. By undermining markets, also the whole climate finance package is undermined. So this issue goes straight into the heart of the negotiations in Doha.

Finally, he said, the discussants had emphasized that carbon markets is not only about cutting emissions at the minimum cost, but it is about discovery of new ways of developing and growing, about opportunity and access, and for integration of mitigation, adaptation and development. We heard a common vision beyond simply cost cutting, to what equitable access to sustainable development really means. This is also a process of discovery of new ways, and more attractive ways, of doing what is needed to meet the climate change threat.

The meeting ended at 15.00.

The on-demand web-cast recording of the Ministerial Dialogue can be accessed at http://unfccc4.meta-fusion.com/kongresse/cop18/templ/play.php?id_kongresssession=5721&theme=unfccc