



2. **MARKETS: Emissions offsets -- a subsurface headache for Copenhagen's players** (12/07/2009)

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UNITED NATIONS -- As some 15,000 people gather in Copenhagen for a high-profile effort to create a follow-up treaty to the Kyoto Protocol agreement, some of the delegates will be absorbed in a more mundane, but important task. They must figure out how to reform the Clean Development Mechanism, one of the protocol's most visible and controversial parts.

But with so much emphasis placed on merely getting a new agreement, and with time carved out for high-level events, CDM watchers expect little in the way of progress to come out of the discussions.

"In terms of CDM reform, it's mostly going to be on process side and Executive Board side," said John Romankiewicz, an analyst at New Energy Finance. "We're really not expecting major changes yet in the way CDM works."

The managers of the Clean Development Mechanism, a group called the Executive Board, have been taking steps to improve and speed up the process, following requests issued from earlier meetings. But nations are now discussing the option to radically alter the very structure of the CDM after the Kyoto Protocol's first compliance period ends in December 2012.

The biggest proposal on the table so far is to move away from the current project-by-project-based system to a more "sectoral" approach as touted by the European Union, setting up a system whereby emission offsetting is targeted at entire industrial sectors. Observers say E.U. officials are strongly pushing the idea on China, India, Brazil and other large developing nations -- the hosts of the majority of CDM projects that industrial nations pay for as a cheaper way to achieve their emissions reductions.

The plan would give more substance to recent promises by India and China to reduce the "carbon intensity" of their economies as they become more energy efficient. Under the European Union's proposal, nations would calculate what emissions from a certain industry would be under a business-as-usual scenario. The large developing states would be committed to keeping emissions under a certain level as their economies grow, but could earn CERs or other types of credits if industries perform even better than expected.

'A radical rethinking' under way

It's a radical rethinking of the CDM that "would basically put all the weight on the host government," Romankiewicz said. It would also take years to work out the details and would almost surely meet with resistance from those who are already critical of carbon offsetting.

If any reforms come out at all from this latest round of negotiations, they will likely be much more incremental than the creation of a sectoral CDM, experts say.

CDM reform efforts, now dragging on for years, are becoming increasingly bitter as the Executive Board gets more stringent in doling out millions of dollars' worth of Certified Emission Reductions (CERs), the United Nations' official carbon offset credit. As investor frustration builds and developing nations grow fearful of the possible end of the CDM, what was once a quiet discussion on the sides of climate change talks is now turning into a virtual shouting match.

The issue of CDM reform was brought to the fore last week after it was announced that the Executive Board is rejecting 10 wind-power projects in China on the grounds that they violate the CDM's "additionality" requirement, the controversial rule that offset projects must prove they wouldn't have happened without the opportunity to earn CERs. It's a decision that's groundless, emissions trading experts say.

"I honestly do not understand it," said Kim Carnahan, an official with the International Emissions Trading Association (IETA) who is in Copenhagen this week to press for CDM reform. "I do not understand why you would disincentivize something that is obviously beneficial as wind power."

Carnahan says that the rejection of the wind projects brings to light just how arbitrary and unpredictable Executive Board decisions are. Her criticism echoes numerous other complaints by CDM critics that the Executive Board seems to keep changing the rules as it goes. Project developers, this argument goes, have no recourse and can't appeal rejections; meanwhile, the process is bogged down with applications easily taking a year or more to get through the system.

A Chinese puzzle

"As the Executive Board undertakes reforms to incorporate more objective, standardized criteria into additionality determinations, it will be possible to create a program that both ensures offset quality and is not overly burdensome or administratively complex," conclude researchers with the Offset Quality Initiative (OQI), a coalition of six climate change organizations.

The China wind dispute is only the latest in a series of Executive Board decisions that have riled project developers and carbon traders. Observers note that in the past two years, the board has greatly increased the number of projects it pulls aside for review. The rate of rejections is also increasing as board members work to dispel concerns that illegitimate projects are being awarded lucrative carbon credits.

Last Friday, IETA issued a report heavily critical of the CDM as it is now run, detailing its concerns and recommendations on how to improve them. Citing an "enduring lack of predictability and consistency," the trade group warned that would-be offset project investors are now pulling back in droves. The decision on Chinese wind will only fuel this trend unless reforms are immediately carried out, it said.

"We're not kidding. Investors are pulling away, and they're pulling away fast," said Carnahan in an interview. "These messages that I've already gotten are stop investing in wind projects, and not just in China, either. It sends a negative message to all other countries that might be thinking about putting in a feed-in tariff."

Shortly after launching its report, IETA issued a statement loudly condemning the Executive Board's decision on Chinese wind producers. Board members say they have uncovered evidence that authorities in Beijing are deliberately adjusting the subsidies to wind projects to make sure to keep them eligible to receive CERs.

How do you define and enforce 'additionality'?

The CDM office in Bonn, Germany, defended the board's decision, insisting that it is limited to this particular case, as the projects owe their existence to Beijing's feed-in tariffs for wind and not to CER revenue. The decision doesn't effect other wind projects that may still be eligible, the office said.

"Projects must produce emission reductions that are additional to what would have occurred without the project," CDM officials said in a note. "These so-called tariffs are revenue for the projects and, as such, factor in the financial viability of the projects, and thus the determination of additionality."

Still, investors are demanding more transparency and clarity in CDM board decisions. Greater standardization of the process of project approval and rejection is also needed, and proponents of reform want the delegates in Copenhagen to finally allow carbon capture and storage projects. Traders also desperately want nations to set up an appeals process, independent of the Executive Board, and other strict guidelines to correct "a glaring neglect of administrative due process rules to ensure basic procedural fairness" that IETA and others see.

Michael Gillenwater, director of the Greenhouse Gas Management Institute, believes that much of the problems that plague the CDM could be due to a simple lack of expertise. Carbon calculating, offset project decisions and emissions trading are all relatively new fields still being developed. Project design, auditing and approval could be enhanced and streamlined with just better training, he said, pointing to a need for some sort of professional accreditation procedure.

"The analogy would be passing the bar, the medical board, or becoming a CPA [certified public accountant]," said Gillenwater. "Professional certification is a very common format for industries throughout the economy ... and as the carbon market grows, part of the problem is that we need a clear pathway for people to get into the field."

But the way changes are now moving forward -- at a snail's pace -- isn't working for carbon traders. IETA wants delegates at Copenhagen to appoint a separate body that would meet year-round and devote itself exclusively to enhancing the program. Simply forwarding yet another set of recommendations to the Executive Board isn't sufficient, it says.

"Last year, they had over 40 different things they asked the EB to do, and the EB is so busy doing their daily work that they get around to doing almost none of them," said Carnahan. "This is the kind of process that's been going on the past four years."

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