World Business Council for Sustainable Development

International Chamber of Commerce
The world business organization

Mexican Dialogues

Role and Architecture of Markets

Bonn, 16 October 2010

This report is arranged in two sections. The first part is a series of key messages and recommendations from the meeting. These were not "agreed" during the dialogue but are the rapporteur's attempt to bring together many of the diverse opinions expressed by the participants. The comments expressed were made on a personal basis and do not necessarily reflect those of the government or organization which they represented.

The second part is an Annex in which are the key messages that were expressed by the participants and many of the speakers.

A number of key questions were posed to the participants. These are noted below. The questions/topics were addressed in a number of individual sessions.

- *Role of markets in delivering low-carbon technology and finance*
- *Scenarios from the business community - the GHG market today and post 2012, including different national demand assumptions*
- *How does the UNFCCC process impact the carbon market? What issues need to be addressed?*
- *Is there a role for the Clean Development Mechanism in the long term? How does CDM fit in the future architecture of a market?*
- *The role and characteristics of future mechanisms including supply/demand - Why are they needed?*
- *What is needed from Cancún, what is possible from Cancún? What is the role of COP outcomes on business confidence and willingness to invest?*

Messages and recommendations

Recommendations: What is needed from Cancún, what is possible from Cancún?

- In Cancún negotiators, must try to *re-build the broken confidence* between Parties, as well as with stakeholders.
- Recognition must be given that there is a need for *a business consultative mechanism* that can provide an orderly way for business input in the process. Business has no interest to become a Party to the negotiations. Business plays a unique role as it is called to implement most of the provisions negotiated.
- *Carbon markets are only one tool in a multi-tool box*, one that is necessary but not sufficient; what is also needed is research and development (R&D) to help emerging technologies.
- The continued *ideological opposition to markets has to stop*. It doesn't reflect the societal realities and there is no desire to impose market participation on those that

do not wish to do so. However, the continuous opposition to a discussion on markets will only ensure that the multilateral process will have no role to play in what will be a critical part of the response.

- *Government intervention in markets to control prices is not appropriate*, if the government wants to influence technological development, it should use other means. The carbon market should be used to get emission reduction results.
- *Trust is falling in markets from both sides* – the public is losing faith that they can deliver due to the continuous uncertainty and is suspicious of markets in general, business is losing confidence in the carbon price signal and is unsure about its continuity.
- Cancún is unlikely to establish the needed market global framework, but instead should be used *to establish a work program to create the architecture and its elements.*
- There needs to be recognition of the new realities in carbon markets – fragmented, with many offsets and many units that should be fungible -- vs. the old Kyoto paradigm (i.e. top down, structured, an AAU accounting system framework to allow international trading between system).
- *The international negotiations should set standards for MRV* in the various systems and a mechanism and criteria for recognition of the various units that will ensure their fungibility.
- This "patient" needs medicine – *Cancún must provide a clear resolution that mechanisms such as CDM will continue*. Doing without market mechanisms is simply unrealistic, so the COP needs to embrace their use. This is what business responds to.
- *CDM and JI should become universal and available to all jurisdictions* where there is demand for offsets. The current mechanisms, CDM and JI, should not be used as leverage in political negotiations.
- *Reform of the CDM Executive Board to improve transparency and efficiency is essential*. Business wants an explicit statement on the continuation of the CDM post-2012 and that private entities will be able to participate directly in new mechanisms.
- *New mechanisms need to be developed* to allow a smooth transition. Approaches including programmatic and sectoral approaches could support the type of large-scale projects to deliver emissions reductions and support the multitude of projects needed. We should build on what we have to save time. There is a lot of institutional knowledge linked to the CDM and this must not be lost. It will take several years to develop a new approach. The process must be started now and there must be a smooth transition from existing to new scheme.

ANNEX

Discussion Highlights

1. Role of markets in delivering low-carbon technology and finance?

- We should consider the energy system we have today, which is 160 yrs old and built almost entirely as a market-based initiative. Market changes direction when you price an externality and can do so at an astounding rate. It is difficult to change existing energy system and infrastructure, but with a significant carbon price, we can move very quickly.

- This is a unique challenge because to the final consumer, the output is the same. There needs to have a policy to drive change. This requires a public-private partnership as this is a market failure to recognize the limitation in the ability to emit carbon in the atmosphere - the private sector cannot do this alone. A low-carbon energy system cannot emerge without a carbon cost. Beauty of markets is that they provide a lower-cost way of getting there than government regulations.

- Having a price on carbon has helped companies operating in Europe establish a carbon strategy for the future. Carbon markets are only one tool in a multi-tool box, one that is necessary but not sufficient; what is also needed is R&D to help emerging technologies. The carbon market will interact with other policies; need to look at the way they interact in order to get the right outcome. Different tools will be used depending of the stage of the technology.

- In addition to efficiency, the challenge to be faced is leverage and scale. History of markets, including emissions trading under The US Clean Air Act, as well as the CDM, have demonstrated the resilience of markets - once established, they are hard to dismantle. When you set up a market-based system, you are setting up a sustaining, lasting system, which simply regulation doesn't always achieve.

- A well-regulated market, should: (1) provide a long-term clear path on what emission reduction targets would be, (2) as a regulatory framework be stable over long term, (3) insure they provide flexibility measures to guarantee smooth transition, (4) and monitor and prevent against fraud.

- Key question is, how do you make markets work in countries that do not have the infrastructure and capacity to operate sophisticated markets that require significant amount of data? How can this be we overcome?

- With markets, you only get your money when you deliver. Payment only happens when the reduction takes place rather than when it is invested. That creates environmental certainty in terms of delivery but also the difficulty that projects do not get upfront finance – which can be a challenge.

2. Scenarios from the business community - the GHG market today and post 2012, including different national demand assumptions

- The $100 billion per year enshrined in the Copenhagen Accord, 70% is set to come from the private sector. Even more so now, given the fiscal balances of governments. So, can we ensure that the markets we have operate to achieve most reduction at lowest cost?

- Lessons from the EU ETS should be seen as lessons for the operation of a carbon market in general, not as a European experience only. They should be internalized for as the lessons learned from the operation and of an internationally, multilaterally-operated and regulated offset production and its relationship with national or regional cap and trade system.

- One key lesson is that there cannot be two regulators for the same aspect of the market, in this case, quality of offsets. Both the CDM EB of the UNFCCC and the EC wish to regulate what constitutes valid offsets. This creates confusion with market players as well as tensions between those that negotiate terms and conditions under the UNFCCC.

- ETS is different than any other commodity market: supply side is fixed years in advance. This is a problem when you have a recession because you set the cap based on an economic growth outlook that was much more positive than we are now facing. We now have the worst of worlds in Europe- you have a price on carbon that is hitting consumers at a bad time, but the price isn't high enough to make a dent in the reductions required.

- However the EU ETS has done exactly what it was supposed to do. It's not the market's fault that the recession did a lot of its work for it. What is the problem: the EU has given the best signal that the EU could ever give by setting, as a matter of law, a target to 2020?

- There should be a more flexible EU ETS design in Europe but more stable and predictable regulatory framework, including in its relationship with the CDM and JI part of the market. Otherwise, the market won't get the outcome it's meant to and people will start to question whether or not it is the right tool to tackle the climate challenge.

- The size of the Kyoto Protocol (KP) compliance gap has been so impacted by the recession, that there isn't much problem meeting commitments. Where the problem lies is with the bankability of AAUs into the next commitment period.

- The main driver is to reduce emissions. This is a hugely important point and flexibility is needed because this is a moving target- we might find out that we need to be moving faster to cut emissions that initially recognized

- There is much more pessimism today about the carbon allowance being the most valuable traded currency in the next 10 years, due to the negative developments in

the US. But there is still activity in the US at the regional level and all hope is not lost.

- The public is being asked to make a very big change in the way it uses energy and the rationale has not been explained well enough so far.

- Is there a need to a global/regional intervention, such as a Federal Reserve of the carbon market, rather than the various regional schemes.

3. How does the UNFCCC process impact the carbon market? What issues need to be addressed?

- Regarding the potential gap- will Joint Implementation and the Clean Development Mechanism (CDM) continue, will emission trading continue? It is difficult to answer these questions because when the KP was designed, it was expected to be a long-term instrument, with more compliance periods to follow.

- But this is bigger than the mechanisms, it's the whole climate change regime is under consideration now. What happens in the gap is linked integrally to other aspects of the negotiations.

- The future of the KP mechanisms is tied to developed country mitigation commitments, size and form.

- Impact of surplus AAUs, as market participants cannot determine at this stage if all or any of these can be banked. Since the volumes expected are very high it has large impact on prices.

- Government intervention in markets to control prices is not appropriate, if the government wants to influence technological development, it should use other means. The carbon market should be used to get emission reduction results.

- Sees no explicit link of the CDM with second commitment period of the KP. Some take the view that if there are no targets, then there is no need for an offset mechanism. However, there is the EU ETS and other existing and potential domestic schemes for demand. It is a political decision.

- We must avoid retrospective application of rules and seek the development of standardized baselines.

- Reform of the CDM Executive Board to improve transparency and efficiency is essential. Business wants an explicit statement on the continuation of the CDM post-2012 and that private entities will be able to participate directly in new mechanisms.

4. Is there a role for the Clean Development Mechanism in the long term? How does CDM fit in the future architecture of a market?

- There is a necessity to regulate the CDM market taking into account perspectives of the people who invest real money in this market.
- CDM is losing its monopoly position and is now competing with other national and voluntary processes.
- Bottom-up initiatives risk fragmenting the market, being un-coordinated and will be developed without necessarily including the concerns of LDCs and vulnerable countries.
- Overhauling the CDM process, including digitalising the work flows and ramping up the CDM secretariat is critical to speed-up the process for project approval and to develop trust in the process
- A pragmatic balance between perfection and sufficiency is needed, without undermining the environmental integrity of the whole while overcoming the difficulties of a "baseline and credit" system
- Improvements of the CDM should be a continuous priority Cancún, but its credibility will remain in question, particularly in view of the current trend to fragmentation.
- Improvements to the CDM format will be helpful but not sufficient to achieve the estimated emissions reductions needed given the scale of development in the emerging economies.
- There is a shared interest in providing continuity to CDM and to market mechanisms. At the same time new mechanisms need to be developed to allow a smooth transition. The dependence of CDM on the Kyoto Protocol and a demand generated by Annex I targets, produces uncertainty in view of the debate over a second commitment period under the Kyoto Protocol.
- COP/CMP 16 should send a strong message on the security and continuity of the CDM and market mechanisms.

5. The role and characteristics of future mechanisms including supply/demand - Why are they needed?

- New approaches including programmatic and sectoral approaches could support the type of large-scale projects to deliver emissions reductions and support the multitude of projects needed counter the 300 GW coal installations which are planned to be installed in the next 20 years.

- We should build on what we have to save time. There is a lot of institutional knowledge linked to the CDM and this must not be lost. It will take several years to develop a new approach.

- The process must be started now and we must have a smooth transition from existing to new scheme. At the same time we must not lose sight of the CDM reform.

- Any new "mechanisms" must ensure that business can participate. Today many find the CDM too cumbersome to even consider. Simplification is possible and necessary. MRV will be critical for private sector confidence in future market mechanism

- There must be some way of accrediting and reconciling different crediting schemes – otherwise there will be doubt that a ton is a ton.

- Set stable rules and be able to revise them according to defined/understood time table - must avoid retrospective changing of rules. Need to learn by doing - i.e. take some sectors to start.

- Mechanisms need to be flexible - i.e. account for differing national circumstances and priorities - one mechanism won't fit all.
